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TAX REFORM PROPOSALS—XIII

HEARING

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UNITED STATES SENATE

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(Debate on Alternative Retirement Arrangements)

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TAX REFORM PROPOSALS—XIII

THURSDAY, JULY 11, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Symms, Grassley, Long, Bentsen, and Bradley.

[The press release announcing the hearing follows:]

[Press Release No. 85-048]

TAX REFORM HEARINGS IN FINANCE COMMITTEE TO CONTINUE IN JULY

Examination of President Ronald Reagan's tax reform proposal will continue in July with a series of hearings before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon), said today.

"We made a good start on the hearing portion of this long process toward overhaul of the Internal Revenue Code during June," Senator Packwood said. "The hearings we have scheduled for July will take us further toward our goal of having a bill to the President by Christmas."

The hearing announced today by Senator Packwood include:

On Thursday, July 11, witnesses invited by the Committee will present their views on tax reform and alternative retirement arrangements.

The CHAIRMAN. The hearing will come to order please. I want to welcome our witnesses today to this hearing on alternative retirement arrangements. The purpose of this hearing is to try to enlist our witnesses' help so we can learn a bit about the uses of various forms of retirement programs. In 1982, in TEFRA, as well as the Deficit Reduction Act last year and now—as we examine proposals for tax reform—the members of this committee have continually heard mention of different forms of retirement arrangements—IRA's, 401(k) plans, defined benefit plans, defined contribution plans, thrift plans. What I hope we can focus on today is the difference between these types of arrangements and on the differences between employers or workers who use one or more forms of these plans.

I know many of you here today have specific concerns about the retirement provisions of the administration's proposal. I have some specific questions concerning the administration's plans. I want to assure you, too, that your written testimony will be part of the hearing record, but what I really want you to spend the bulk of the committee's time on today is to try to understand some basic retirement policy issues, such as:

First, what are the advantages of various kinds of retirement arrangements being offered today?

Second, what types of workers use these different arrangements?

Third, how has the Tax Code encouraged or discouraged these arrangements in the past?

Fourth, how should the Tax Code affect these arrangements in the future?

We have an excellent group of witnesses here today to help us with these questions. Some have practical experience in administering retirement plans; others are from the academic world; still others who have participated in industry studies on these issues. I want to thank all of you for agreeing to participate in this type of hearing. I realize it is more difficult to prepare for this kind of format than a traditional hearing, but we believe this format has been successful in helping and educating the committee on other issues during the past few weeks. Now, I would like to call on Senator Danforth, who, I believe, has an opening statement.

Senator DANFORTH. Mr. Chairman, thank you very much. I do have an opening statement. I would like to compliment you, Mr. Chairman, on the job that you have done, not only in arranging hearings on the tax bill, but your conduct of the business of the Finance Committee since you assumed its chairmanship. You have been faced, as chairman of this committee, with two major responsibilities. The first responsibility was the whole question of the budget resolution and the general problem of deficit reduction. Obviously, anything dealing with the Federal budget is of great concern to the Finance Committte because we have jurisdiction over all of the revenue-raising measures, and we have jurisdiction over something like two-thirds or three-quarters of the Federal spending; and therefore, the budget is a matter of major interest to the Finance Committee.

In addition to that, the President has initiated a tax reform proposal—two tax reform proposals—and you have scheduled I don't know how many days of hearings over a period of months, so that the Finance Committee could be thoroughly informed as to the implications of the various proposals that have been put forth for tax reform. The President has indicated that the question of deficit reduction and the question of tax reform are two matters that should be proceeded on two different tracks at the same time. I think some of us had some questions as to whether a two-track theory was the right theory. Many of us believed that tax reform was something that was interesting and worth looking at, but that it is clearly of secondary importance to the primary concern of getting the Federal deficit under control. We believe—and I was one of the people who believed—that correcting the problem of the Federal deficit has to come first and foremost and that everything else has to be secondary, compared to the Federal deficit. But the President said no. He wanted the deficit and he wanted tax reform to be on two different tracks.

It appears, as of yesterday—after a meeting at the White House—that the deficit-reduction track has been derailed, that we are going to come out with a budget resolution which will save—according to the people who are on our Budget Committee—maybe $30 billion in 1986. I noticed in the morning paper that Senator

Chiles said maybe $40 billion in 1986. Whether it is $30 billion or $40 billion, it is clear that the so-called compromise that was agreed to yesterday is no compromise at all. Oh, it may be a compromise between President Reagan and the leadership of the House of Representatives, but it is no compromise from the standpoint of the Senate, and it is no compromise from the standpoint of all of the experts who have testified before various committees of the Congress.

Mr. Chairman, one thing that you did last winter—shortly after you assumed chairmanship of the Finance Committee—was to convene a panel of leading economists. They were economists across the board philosophically. They included the former Chairman of the Council of Economic Advisers under President Carter, as well as two former Chairmen under Republican Presidents. And each one of those economists told us of the problem of Federal spending and the problem of the deficit of the Federal budget, and the concensus between them was that we had to come up with deficit reductions in 1986 of between $50 and $60 billion—at a minimum—and further, we had to be on a trend line toward a balanced budget by 1990. That is what they told us, for the sake of the economy.

Charles Schulz, who was the Carter economic adviser, said that failure to meet that goal would be like arsenic poisoning for our country, that the country would get weaker and weaker as a result. Now, what has happened as a result of the alleged compromise between the President and the House leadership is that we have taken that advice and we have scrapped it. We, as a government have said, in effect, that we don't agree with the economists or if we agree, we are not going to act on their advice. The deficit reduction is secondary or tertiary on our list of things to do, that there are many more important priorities, such as no tax increase, or such as holding the entitlement programs absolutely harmless. I think it is a serious matter to derail the budget process. I believe it is going to have disastrous consequences—short term and long term—for the future of our country. The one thing that you have given me some responsibility for, Mr. Chairman, is the area of international trade. Everyone is aware of the trade deficit—a $123 billion international trade deficit last year. It is going to be $140 or $150 billion maybe this year and going up. Why is the trade deficit—a large reason for the trade deficit is the deficit in the Federal budget.

The decision was made yesterday between the House of Representatives and the President of the United States to just let the trade deficit continue to go through the roof, and I think that is wrong. We have got a farm bill that is stalled. You know it is amazing what we do around this Congress. We pass gun control bills, or antigun control bills. We can't pass farm legislation, and we can't responsibly deal with the budget resolution. But in any event, we have this stalled farm bill. A lot of people express concern about the plight of the farmer—and they are certainly in very bad shape in my State. The most important thing we could do for the farmer is get interest rates down and get exports up, and that, too, is related to the budget deficit. And yet, we have ignored the problem of the deficit of the Federal budget.

Mr. Chairman, I compliment you on the hearings you are holding on the tax bill, but I am beginning to wonder whether we should have a tax bill. I mean, I like the idea of tax reduction, if we can have it, but if the CBO is correct that this isn't a revenue-neutral bill, this is going to lose yet more revenue. We can't do that to this country. And even if it were a revenue-neutral tax bill, is it right for us to decide to disrupt the economy of America and to impair our economic future by these large budget deficits, and then further to pass momentous tax legislation which even if, on balance, it is good, is certainly going to have a disrupting effect with respect to particular sectors of the economy that are going to be affected by it? I don't know. But I do know this, I am terribly concerned about what we are doing.

I think that it is totally irresponsible to disregard the advice of every major economist and to scrap the budget process and to come up with something which isn't half a loaf, it isn't a compromise. It is a total defeat for what we did in the Senate. You know, last spring, we had that traumatic night on the floor of the Senate. Senator Pete Wilson, who had had an emergency appendectomy the day before, was wheeled onto the floor in a wheelchair with IV's in his hand, to create a tie, which was broken by the Vice President, in order to pass the budget resolution to save about $300 billion over a 3-year period of time. And we thought at the time that that was one of the great moments of the Senate and that we had done the right thing. And it turned out that he may as well have stayed in the hospital, that it was all for naught, and that it led to a total rout—a total disastrous defeat—in the White House yesterday. Now, I don't know what we are going to do about this tax bill, Mr. Chairman. I know this: That my original thinking about it is that, on a scale between 0 and 10, deficit reduction was at 10 and the tax bill was maybe about a 5 or a 6; but if we are not going to have deficit reduction, I am just wondering about whether we should even have a tax bill. And it seems that, at the least, we shouldn't go rushing off with business as usual on a tax bill, given what happened yesterday.

I am just wondering if, sometime between now and if there is ever going to be a markup of this thing, I am just wondering if sometime we could have those economists back and if we could review the report card of the Congress of the United States and the administration over the last year—to review the total effect of what has happened on the budget and to ask the economists, given that—given whatever the effect is—what has happened since they last were here—whether we should proceed with this tax bill or with anything like it.

The CHAIRMAN. Jack, as usual, you are eloquent. I don't know what they say now. My hunch is they would be even more desperate now than they were then. That was January, and you recall what they said. They were testifying about the budget and not about a tax bill. We didn't have any tax bill at the time. And what they said is: If we adopted a budget package that had $50 billion in cuts next year and $100 billion the year after that and $150 billion the year after that—roughly a $300 billion package over 3 years—we could look to a 2- to 3-percent drop in the interest rates. Or as one phrased it a little more carefully, they will be 2- to 3-percent

less than they would otherwise be because that particular one wasn't sure if they might go up anyway, but they would be 2- to 3-percent less than they would otherwise be. They were not commenting on taxes at all. They weren't called to comment on taxes.

Today, I bet you they would come and they would say to the gentlemen of this committee: The situation is even more desperate. Last January, we were presuming a 4-percent growth rate. While we even had some questions about it then, it is very clear that we are not going to have it at least this year now. And therefore, the deficit will be wider, all other factors being equal. The deficit is going to be wider than it otherwise would have been under the assumptions of January. This committee—not in formal meeting—met as our part of the deficit reduction and I thought did very well, in both Republicans and Democrats, in the cuts we said we could make in Medicare and Medicaid and other areas of our jurisdiction. We did not at that time consider, one way or the other, Social Security firmly, although we had a variety of alternatives of 1 percent, 2 percent, 3 percent, or 2 percent, 2 percent, 2 percent, or zero increase for 1 year and back to COLA's—a variety of alternatives, any one of which, if adopted, together with the Medicare, Medicaid, and other cuts, would have produced about a $60 billion saving out of this committee's jurisdiction alone. I share your disappointment. I don't know where that budget comes out.

At this stage, I don't know if I can bring myself to support that budget. That has nothing to do with the tax bill here. There are few things worse in Government than misleading people; and if that budget is full of phony assumptions and fraudulent hope, we would be letter off not to mislead the people and simply turn it down. We are ready to start. We have today in our first two panels a form of debate that we have used before, and it is, again, most helpful to us to have the give and the take of professionals who understand the subjects we are talking about. So, our first issue is as follows.

Is it appropriate for the tax system to increase emphasis on individual savings initiatives, like individual retirement accounts, rather than employer-sponsored retirement plans? Arguing for the affirmative is Peter Ferrara, an attorney at Shaw, Pittman, Potts & Trowbridge in Washington; and for the negative, Harry Smith, a pension and benefit policy consultant with the Sun Co., in Radnor, PA. Gentlemen, do you want to come up?

Senator CHAFEE. Mr. Chairman.

The CHAIRMAN. Oh, I am sorry, Senator Chafee. I didn't see you come in.

Senator CHAFEE. Well, I came in quietly. [Laughter.]

And late. Mr. Chairman, I missed the previous discussion of Senator Danforth, and I presume you had some comments, too, on the deficit—on the budget. Let me just say that I am deeply distressed over this suggestion of a so-called compromise on the budget. What the House is proposing is the worst of all worlds. Take the Senate figure on defense and the House figure on not doing anything about the cost of living adjustments, I think if you look at the problems of this Nation, everything is eclipsed by the deficit this country is running. This is important—what we are doing here—but this is nothing in comparison with the urgency and the threat to

the country that is provided by those deficits. I don't know where we are going to come out, but I just wish somehow that the Senate figures on the cost of living adjustments could be adopted. Furthermore, I would go along with deeper cuts in defense. Let's get these deficits down. If anybody can sound the alarm or if one more voice can be added to the sounding alarm, I would wish mine to be so recorded. Thank you.

The CHAIRMAN. Thank you. Senator Symms.

Senator SYMMS. I don't have any questions at the present time, Mr. Chairman. I would just like to apologize to the witnesses since I can't stay here to hear their testimony because we are conducting hearings on the reauthorization of the Surface Transportation Act in the subcommittee which I chair, and we are going to start at 10. So, I am going to have to leave, but I welcome these witnesses. I have worked on some of these issues that the witnesses are presenting here this morning, and I am certainly interested in what they have to say. And I will look forward to carefully studying what they do say.

The CHAIRMAN. Senator Grassley, any opening statement?

Senator GRASSELY. No, Mr. Chairman.

The CHAIRMAN. Mr. Ferrara, why don't you go right ahead.

STATEMENT OF PETER FERRARA, ATTORNEY, SHAW, PITTMAN, POTTS & TROWBRIDGE, WASHINGTON, DC

Mr. FERRARA. OK. To begin in addresssing the question that I have been asked to speak on today, the first point that must be recognized is that IRA's are not just a vehicle of retirement policy. Many tax theorists believe all investment should be taxed in the same way IRA's are taxed under current law. IRA's merely provide for expensing of investment, which if applied to all investment would create a consumed income tax system. A major expansion of IRA's is justified on these grounds alone, to bring our income tax system closer to a consumed income tax system, regardless of retirement policy.

Now, in regard to retirement policy, both IRA's and employer-provided pensions need to be maintained as strong, viable options. This maximizes the degree to which retirement support can be provided through the private sector and, consequently, reduces the burden on Government of providing such support. The President's tax reform plan recognizes this and, consequently, leaves the favorable provisions for pensions mostly intact. The fact is that, apart from what I view as the unfortunate proposed increase in withdrawal penalties for employer-sponsored savings plans, the administration's tax reform proposals do not meaningfully reduce the role of private pensions, but rather eliminate abuses and adopt other reforms which make good sense as a matter of policy, regardless of what is done with IRA's. And the administration's tax reform, which effectively retains pensions while proposing to increase IRA's, shows there is no real conflict between the two.

Nevertheless, if one must compare pensions to IRA's, then one must point out the many ways in which IRA's are clearly superior for workers. The first reason is that IRA's have far superior protability and vesting features. Portability and vesting will always be

enormous problems for employer pensions, but with IRA's, workers have instantaneous vesting and maximum portability. And this is good not only for the worker, but for the economy as a whole. Pensions tend to reduce mobility and, consequently, efficiency in the work force by tending to tie workers to one particular firm. With IRA's, this is not a problem.

Employers are also able to establish pension features that suit their own purposes and goals and not necessarily those of the workers. They can structure pensions to induce employees to stay with the firm longer than they want or to retire earlier than they want or to retire later than they want. They can manage investments of the pension funds to their own benefit, rather than maximizing the benefit to workers. With IRA's, by contrast, the worker can tailor investments and benefits to suit his own individual needs and preferences. The worker enjoys maximum flexibility. He is free to retire when he wants, without penalty, to switch jobs when he wants, and to invest to maximize security and returns.

Workers can also actually generally get higher investment returns through IRA's than has been earned by pensions. Simple broad-based investment pools, such as broad-based mutual funds—which are easily available to all IRA investors—have historically earned much higher returns than employer-managed pensions.

In addition, IRA's reduce taxes on the little investor, whereas the pension provisions primarily reduce taxes on big business. Big business does no favor to workers through pensions. It is merely providing compensation that workers have won in the marketplace. It would have to provide equivalent compensation to employees in one form or another in any event. At the same time, I want to emphasize that if you look at the figures carefully, you will see that the income distribution of those who own IRA's is not that different from the income distribution of those covered by pensions.

Now, these comments primarily apply to traditional employer pensions, as opposed to employer-sponsored savings plans, such as 401(k)'s. The employer-sponsored savings plans, such as 401(k)'s are basically the same for workers as IRA's, except they are available only to workers who happen to have employers who have set up such plans. Profit sharing and stock bonus plans may also suffer from portability and vesting problems, limited investment flexibility, and again a tendency to favor the employer's purposes rather than the employee's. Therefore, expansion of savings plans for workers should clearly be focused on the universally available and maximally flexible IRA system, rather than the more narrowly available employer savings plans.

Now, on the basis of this analysis and on the written testimony which I have submitted, I would recommend that the committee adopt the President's tax reform proposals regarding pensions and IRA's as is, except for the following minor modifications. One, the maximum IRA contribution limit should be indexed to inflation. Two, the withdrawal penalties for IRA's and employer-sponsored savings plans should not be increased. In fact, I would recommend that there should be no withdrawal penalties for the items the administration plan favors; that is, college expenses, unemployment support, and the first purchase of a principal residence. And the third recommendation is to not apply the proposed excess retire-

ment benefits tax to IRA benefits. Mr. Chairman, that concludes my opening comments.

The CHAIRMAN. All right, Mr. Ferrara. Thank you very much. Mr. Smith.

[The written prepared statement of Mr. Ferrara follows:]

STATEMENT

before the

SENATE FINANCE COMMITTEE

June 11, 1984

By

PETER J. FERRARA

STATEMENT

The question I will address in this testimony is whether tax policy should shift more in favor of Individual Retirement Accounts (IRAs) or employer provided pensions as vehicles for enhancing retirement security, particularly in light of the President's tax reform proposals.

I.

The first point that must be recognized is that IRAs are not just a vehicle of retirement policy. Many tax theorists believe that all investment should be taxed in the same way IRA investments are taxed under current law. IRAs merely provide for expensing of investment, which if applied to all investment would create a consumed income tax system. This treatment eliminates all biases against investment otherwise inherent in an income tax, leaving the tax system neutral between consumption today and deferred consumption through investment. Former Treasury Undersecretary Norman Ture, for example, has long advocated this view.

This view was adopted in the famous Hall-Rabushka tax reform proposal, which was advanced in the widely-noted volume Low Tax, Simple Tax, Flat Tax and first stimulated today's tax reform debate. Hall-Rabushka treated all investment as IRAs do

today, while maintaining a 19% flat rate on income in a revenue neutral tax overhaul. Many tax reform proposals currently before Congress embody this Hall-Rabushka investment treatment, including a bill by Democratic Senator Dennis DeConcini from Arizona.

The Treasury Department's tax reform study issued late last year also suggested that a consumed income tax, with IRA tax treatment for all investment, was ultimately the preferred tax system. The Treasury's first proposal consequently included a substantial increase in IRAs, with the goal of eventually having high enough maximum IRA limits so that most Americans would in effect be under a consumed income tax system for the amount of saving they are in any event likely to do. The President's proposal cut back on this IRA expansion due to short term revenue considerations, but I believe Administration officials would still hold to the original goal as a long term ideal.

A major expansion of IRAs is justified on these grounds alone, apart from retirement policy. The annual maximum IRA limit should eventually be raised to $10,000 per family, indexed to inflation, which would in effect create a consumed income tax system for the great majority of Americans. If IRA treatment is simply the proper tax policy for investment, then there is also no reason for withdrawal penalties or restrictions of any kind. Funds would simply be excluded from income

when paid into an IRA, and included in income when withdrawn. This expansion should be held as a long-term reform goal, rather than a short-term proposal.

In addition to providing the most potent and equitable incentives for saving and investment, broadly distributed throughout the whole population, such a system would also greatly encourage individuals to rely more on private savings to serve a wide range of needs now served in large part by government spending and programs. These include not only retirement income support, but also disability support, medical care, education, housing, unemployment support, and others. Increased private saving to serve these needs would remove pressure for increased government spending in these areas, and perhaps even eventually allow the government to reduce such spending, as individuals are able to meet the needs in a far superior fashion through the private sector.

II.

In regard to retirement policy, both IRAs and employer provided pensions need to be maintained as strong, viable options. This maximizes the degree to which retirement support can be provided through the private sector, and consequently reduces the burden on government of providing such support. Cutting back on either one would likely result in increased government spending for retirement support, surely leaving no

additional revenues to reduce tax rates as part of a tax reform effort.

The President's tax reform proposal again recognizes this. It was precisely to avoid decimating employer provided pensions as a private alternative to increased government retirement spending that the Administration's tax proposals leave the favorable provisions for such pensions mostly intact. The fact is that, apart from increased withdrawal penalties for employer sponsored savings plans, the Administration's tax reform does not meaningfully reduce the role of private pensions, but rather eliminates abuses and adopts other reforms which make good sense as a matter of policy, regardless of what is done with IRAs or tax reform overall. The Administration's reform package, proposing to increase IRAs while effectively maintaining favorable treatment for employer provided pensions, shows there is no real conflict between the two.

The tax provisions for employer provided pensions are sufficiently favorable and will, with some minor modifications, effectively remain so under the Administration's reform proposal. There are good reasons of tax policy, retirement policy and social welfare policy to expand IRAs sharply in the future. This needed expansion should not be oppposed on the grounds that tax policy would then be shifting in favor of IRAs over employer provided pensions. The tax treatment of such pensions has simply already matured to a desirable state, while further

expansion of the compartively quite new and much smaller IRA system is still desirable.

III.

Nevertheless, if one is forced to compare IRAs to employer provided pensions, then one must point out the many ways in which IRAs are clearly superior to such pensions.

First of all, portability and vesting are enormously complicated problems for employer provided pensions, and will always be so. IRAs, however, have instantaneous vesting and maximum portability. The worker's rights in the IRA vest as soon as the money is paid in, and the IRA follows the worker wherever he goes. This is good not only for the worker, but for the economy as a whole. Pensions tend to reduce mobility, and consequently efficiency, in the work force by tending to tie workers to one particular firm. With IRAs, this is not a problem.

Employer pensions are also generally designed and structured by employers, and employers tend to establish pension features that suit their own purposes and goals, not necessarily those of the employees. Many employers, for example, may structure their pensions to induce employees to stay with the firm longer than they want, or to retire earlier than they want, or later. The employer will also often have the opportunity to manage the investments of the pension funds for his own

maximum benefit, rather than maximizing the benefits, security, or returns to his employees. Sometimes employers have invested pension funds heavily and even exclusively in their own companies, which is hardly a way to spread risk or maximize returns. With IRAs, by contrast, the worker can tailor investments and benefits to suit his own individual needs and preferences. He is free to retire when he wants without penalty, to switch jobs when he wants, and to invest to maximize security and returns.

One virtue of employer provided pensions is supposed to be that they can take the risk of variation in investment returns off the employee's shoulders through a defined benefit plan, which promises workers a specified retirement income. But these defined benefit plans leave the risk of inflation entirely on the worker. Historically, this inflation risk has substantially harmed retirees as inflation reduced the value of their promised pension benefits. By contrast, employers have tended to profit substantially from variations in expected investment returns, in part receiving compensation for inflation through higher returns. These employer profits have in fact been so embarassingly high at times that many employers have felt compelled to distribute some of the windfall through unrequired, gratuitious increases in promised retiree benefits.

The fact is employers take the easy part of the risk through defined benefit plans, as experience has shown. Workers can easily obtain the maximum protection against

investment return variations through broad based, mutual fund type, investment pools. Indeed, historically such investment pools have paid higher returns than earned on employer managed pension funds. The returns on such pools have also over the long run varied with inflation and consequently compensated the investor for it, as basic economic theory would indicate.

Pension partisans also suggest that employer pensions offer greater opportunities for participation by lower income workers than IRAs. But this inverts what is really going on. IRAs reduce taxes on the little investor, whereas the pension provisions primarily reduce taxes on big business. Pension benefits provided to employees are compensation won by workers in the market, and big business would have to provide equivalent compensation in any event, with or without help from the tax code.

Moreover, the fact is that the income distribution of those owning IRAs is not that different from the distribution of those covered by pensions. Forty percent of IRA participants are workers with under $20,000 in income, compared to 51 percent for pensions. Most interestingly, 13.5 percent of IRA participants earn less than $10,000 in income, compared to 10.8 percent for pension plans.

There are in addition modifications which could be made to IRAs which would improve opportunities for participation by lower income workers. Employers could be allowed to contribute

to the IRA in lieu of the worker. In addition, tax reform proposals such as Kemp-Kasten or Bradley-Gephardt would have all workers deducting IRA contributions against the same tax rate, equalizing the incentive for IRA participation.

The above comments primarily apply to traditional employer sponsored pensions, as opposed to employer sponsored savings plans such as 401(k)s. These plans are basically the same for workers as IRAs, except that they are available only to workers who happen to have employers who have set up such plans. Profit-sharing and stock bonus plans may also suffer from portability and vesting problems, limited investment flexibility, and again a tendency to favor the employer's purposes rather than maximizing the employee's opportunities.

Expansion of savings plans for workers should clearly be focused on the universally available and maximally flexible IRA system, rather than on the more narrowly available and comparatively less flexible employer plans. It appears that the lobbying support for the employer plans stems from the ability to use them to create big tax loopholes for top executives rather than because of their desirability for the average worker.

This does not mean, however, that there is no role for employer sponsored savings plans. These plans may serve to encourage participation by some workers who might not otherwise save in IRAs on their own. Such plans should consequently be a part of any system seeking to maximize private sector support of retirement income.

Ultimately, an ideal IRA system as described above could absorb the role of today's employer sponsored plans. With a $10,000 indexed annual contribution limit, and the ability of the employer to contribute directly to the worker's IRA, employers could play the same role in stimulating greater employee saving as they do today.

IV.

In regard to tax reform, this analysis indicates that the President's proposals for the tax treatment of pensions and IRAs should be adopted as is, with the following minor modifications:

1. The maximum IRA contribution limit should be indexed to increase with inflation. The President's tax reform seeks to index almost everything else for inflation, why not IRAs? Without such indexing, the opportunity for workers to invest in IRAs will be sharply eroded over time.

2. The Administration proposes increasing the IRA withdrawal penalty from 10% to 20%, except for withdrawals for college expenses, the purchase of a first principle residence, or for employment support after unemployment benefits have run out, where the current 10% penalty

would still apply. Increasing the withdrawal penalty will discourage use of IRAs and is contrary to the whole idea that IRAs involve the best way to tax investment in any event. Moreover, we should want to encourage people to save for college expenses, initial housing purchases, and unemployment support, but applying a penalty to withdrawals for such purposes runs directly to the contrary. Consequently, the IRA withdrawal penalty should remain at 10%, with no penalty for withdrawals for college expenses, first residence purchases, and unemployment support beyond the period of Federal unemployment benefits.

3. This same IRA withdrawal penalty should also apply to employer sponsored savings plans, rather than the harsher penalties proposed by the Administration, for the same reasons. Similarly, the Administration's proposed restrictions on withdrawals of after-tax contributions to such plans should also be rejected.

4. The Administration proposes a 10% excise tax for annual benefits for a retiree from IRAs and pensions combined above certain maximum limits. One can see providing a special penalty

tax for excess employer provided, tax preferred pension benefits. But IRA benefits are from the workers own savings. The tax here would simply penalize workers for diligent saving and/or high investment returns earned on such savings. Consequently, IRA benefits should not be subject to the special tax.

STATEMENT OF HARRY G. SMITH, PENSION AND BENEFIT POLICY CONSULTANT, SUN CO., INC., RADNOR, PA

Mr. SMITH. Thank you, Mr. Chairman. The Sun Co., is proud to be here, and frankly, I am pretty pleased about it myself. Rather than getting into details here, let's go back in the early days of the tax system when Federal policy offered incentives to major types of pension plans, to fund benefits, to fund contributions. And the defined benefits—by that I mean an income stream at retirement, usually until death. Recently, industry has added to that spouses' benefits. Then, in 1974, we came up with the IRA's. These plans have grown tremendously. The employer-sponsored retirement and capital accumulation plans—they tell me—have accumulated approximately $1 trillion, whatever that is. And nearly three-quarters of employees 25 years of age or older and otherwise qualified are covered by these plans. They are very broad based because of the nondiscrimination rules. On the other hand, the IRA's have grown tremendously, too, and they have accumulated up to $160 billion, I am told, with nearly 17 percent of the people involved in those plans. The issue here is which to give preference to. Let's take a look at them—what they do. Get down to the basics. What is a pension plan? If indeed it is an income stream on a monthly basis at time of retirement, then the defined benefit plan fits that definiton. An IRA does not. An IRA, if I may call it that, is not a pension plan. It can be made into one if the holder—the owner of it—wishes to annuitize it, but it is voluntary on his part. I don't doubt that we need IRA's because there are a lot of people not yet covered by employer-sponsored defined benefit plans. In 1983 the Census study that HHS made—here are some numbers. Defined benefit systems covered more people than IRA's did. It was 56 percent to 17 percent. Now, regardless of how good a plan is, if only 17 percent are covered, it is not doing that much good. Now, these are the nonagricultural workers. Also—and this is bad—IRA participants generally are older. In that same census, the participants in IRA's between ages 25 and 44 were only 14 percent, as contrasted with 61 percent covered by defined benefits. IRA holders generally are higher paid. Those earning between $10,000 and $25,000 holding IRA's represent only 15 percent of that population, whereas defined benefits had 68 percent coverage. Those earning $50,000 and over—there were 58 percent holding IRA's and 85 percent covered by defined benefits. Take spousal protection. Under the IRA's those who chose—I am told about 55 percent chose spouses benefits—we don't know what it is under defined benefits because you have to—under today's law—have the spouse sign off. I don't know many employees who have that kind of courage. I don't know what the results are. [Laughter.]

The inflation protection. This is not the same census—this is big industry, maybe Fortune 500. I am told about 3 percent have automatic built-in COLA's. IRA's have no such thing. Fifty-one percent of that population give ad hoc increases after retirement. COLA's: zero. If you look at table 13 in the submission we made, you will find the investments of IRA's, and some of them indeed, as Mr. Ferrara suggests, are good; but I don't think they are as good in the long run as the big money managers and the big

professionals are. It is a very professional job, and you know, in the long run if you can get 2 or 3 percent of real return, you are doing pretty good. If you make more than that this year, you are going to lose it next year. You are gambling. And portability—I agree with Mr. Ferrara. You can take it with you much better with an IRA than you can with defined benefits. And so—I see the yellow light on—just one broad statement. I think, without doubt, the most preferred plan in our pension system is the defined benefits plan. There are problems—there are two of them for example. One is special circumstances in which the defined benefits plan really doesn't meet—and I will discuss that later with questions. And the other one is in the accural system of a typical defined benefits plan, an employee cannot earn enough in the short term—cannot accrue enough in a short term employment—to really make it worthwhile if he chooses to move. So, there is a problem there. I think we know how to fix it. Maybe we can talk about it later.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Smith follows:]

Testimony of Harry G. Smith
Sun Company, Inc.

Before the Senate Finance Committee

July 11, 1985

Mr. Chairman, I am pleased to testify before the committee on defined-benefit plans and Individual Retirement Accounts (IRAs).

Almost since the establishment of the personal income tax, the Internal Revenue Code has provided for tax-deferred accumulation of funds in two types of plans. The first is the traditional defined-benefit pension plan, which provides income at retirement in the form of monthly payments. The second is the capital accumulation or defined-contribution plan, which can provide retirement or pre-retirement income in the form of either monthly payments or a lump-sum distribution of the accumulated balance. IRAs, which were first authorized in 1974 and expanded in 1981, are a type of capital accumulation plan aimed at encouraging individual savings.

Defined-benefit plans and IRAs are only two parts of a retirement system which also includes the following components:

- o Social Security will provide 37 million recipients with $171 billion in benefits in 1985.
- o Defined contribution plans had 22.3 million active participants and $300 billion in assets in 1984.
- o Individual savings were reported by 66% of all retirees in 1980.
- o Transfer payments such as Supplemental Security Income (SSI), food stamps and housing assistance also play a role in retirement policy. SSI had 2 million elderly recipients with $3 billion in benefits received in 1983. Food stamps had 2 million elderly recipients with $1 billion in outlays in 1983. Nearly 3.4 million public or rent subsidized housing units were provided for elderly households in 1983.
- o Tax preferences aimed solely at the elderly will provide $19.1 billion in tax benefits to the elderly in 1985.
- o Disability retirement plans cover 91 percent of pension participants in medium and large size firms according to Labor department data.

DEFINED BENEFIT PLANS

Trends in Plan Growth

Defined benefit plans have grown rapidly over the last ten years. The Employee Benefit Research Institute (EBRI) reports that by the end of 1984

there were 240,000 defined benefit plans in operation. This represents an increase of 112,000 plans, or almost 90 percent, over the 1974 level. During the past decade the number of defined benefit plans grew by an average of 7.4 percent per year. Although strong overall, the growth pattern has been irregular. The annual growth rate of defined benefit plans reached its lowest point in 1976, just after the implementation of the Employee Retirement Income Security Act of 1984 (ERISA), when the number of plans in operation actually decreased by 1.1 percent. The rate then climbed to 13.1 percent in 1979, remained above 10 percent each year through 1982, and finally fell to 1.5 percent in 1984 (see Table 1).

Labor department figures show that by 1984 assets held by defined benefit plans had reached $700 billion, or more than triple the 1975 level. The Federal Reserve Board reports that two-thirds of these assets were held in either corporate equities or bonds.

Number of People Participating

In order to be an active participant in a defined benefit plan, a worker must both work for an employer who offers a plan, and meet that employer's participation requirements (the stringency of which are limited by ERISA). A worker is said to be covered by a plan if he is in a job that is eligible for coverage, regardless of whether or not that worker currently participates, because that worker could potentially become a participant by meeting the employer's age and service requirements. As a result, there will always be some covered non-participants; hence, the number of active participants will be smaller than the number of covered workers.

In 1984, 31 million people, or 35 percent of all private workers, were active participants in a private defined benefit plan, according to the Labor

TABLE 1

TRENDS IN DEFINED BENEFIT AND DEFINED CONTRIBUTION PLAN NET CREATION AND GROWTH
1974 to 1984

	Defined Benefit Plans			Defined Contribution Plans			All Plans	
Year	Total Number (thousands)	Growth Rate	As Percent of All Plans	Total Number (thousands)	Growth Rate	As Percent of All Plans	Total Number (thousands)	Growth Rate
1974	128		32%	272		68%	400	
1975	132	2.6%	31	290	6.9%	69	422	5.5%
1976	130	-1.1	30	302	3.9	70	432	2.4
1977	132	1.2	29	320	6.0	71	451	4.5
1978	139	5.7	28	357	11.5	72	496	9.8
1979	158	13.1	29	381	6.9	71	539	8.7
1980	179	13.8	30	410	7.7	70	590	9.5
1981	199	10.7	30	459	11.9	70	658	11.5
1982	222	11.7	30	506	10.2	70	728	10.7
1983	237	6.7	31	537	6.1	69	774	6.3
1984	240	1.5	30	554	3.2	70	795	2.7

SOURCE: U.S. Department of Labor, Memo tabulating data from IRS 5500 and 5500c forms; U.S. Internal Revenue Service, news releases of determination letter statistics.

NOTE: "Total Number" of plans for 1977-80 are U.S. Department of Labor tabulations of data contained in IRS 5500 and 5500c forms. Since all plans must submit one of these forms annually, these numbers represent a count of all plans in existence. For years 1974-76 and 1981-84, these data are not available. Numbers for those years were estimated by EBRI using IRS determination letter statistics.

Details may not add to totals due to rounding.

Department. If public employees and plans are included, the number of participants grows to 46 million people, or 44 percent of all workers. A Labor Department survey found that in 1983, 82 percent of full-time employees in medium and large private firms were covered by a defined benefit pension plan, with the employer usually paying the entire cost.

Even larger than the number of defined benefit plans is the number of defined contribution plans in operation. EBRI reports that by the end of 1984 there were 554,000 defined-contribution plans, or more than double the number of defined benefit plans. However, it is important to remember that by far most defined contribution plans are secondary plans, each coexisting with a primary defined benefit plan. Labor department figures show that in 1984 primary defined contribution plans accounted for only 19 percent of active participants in private employer sponsored plans; the primary plans for the remaining 81 percent of participants were defined benefit plans. The proportion of public-sector participants with primary coverage from a defined benefit plan is similarly high or higher.

Numbers Covered Under Primary Plans

Because most primary pension coverage is provided by defined benefit plans, coverage patterns under primary pension plans in general are a good measure of coverage under defined-benefit plans. Detailed information on pension coverage patterns is provided by the May 1983 Census Bureau Current Population Survey (CPS) Pension Supplement, which was co-sponsored by EBRI and the Department of Health and Human Services.

While the numbers of covered workers and participating workers tend to be different, discussion of the findings of the EBRI/HHS survey will focus on coverage rather than participation, for two reasons. First, evidence suggests

that some survey respondents interpreted questions on coverage to mean actual participation. Second, it is important to remember that by law any private-sector covered employee who meets ERISA age and service requirements must become a plan participant.

A Majority of Employees are Covered. In 1983, 56 percent of all nonagricultural employees, or 50 million workers, were covered under an employer sponsored pension plan, and 45 percent of those covered, having already met vesting requirements, were entitled to benefits at retirement. Among those nonagricultural employees who met ERISA age and service requirements for participation, 70 percent were covered and 53 percent of those covered were already entitled to benefits (see table 2).

Although coverage rates were generally high, small private firms were a distinct exception. In 1983, only 23 percent of workers in private firms with fewer than 100 employees were covered, compared to 76 percent of those in larger firms.

Covered Employees are Found at All Earnings Levels. While employees with high earnings are more likely than others to have pension coverage, those with moderate or low earnings account for the bulk of those with coverage. Only 54 percent of employees with earnings below $25,000 were covered in 1983, compared to 82 percent of employees with earnings of $25,000 or more. However, employees earning less than $25,000 accounted for three quarters of all covered employees (see table 3).

In terms of benefit entitlement at retirement, the vesting rate of covered workers earning $25,000 or more was one and one half times the rate of those earning less than $25,000. However, those earning $25,000 or more accounted for less than one third of those vested (see table 4).

TABLE 2

EMPLOYMENT, COVERAGE AND FUTURE BENEFIT ENTITLEMENT, MAY 1983

	Employment (000s)	Coverage (000s and % of Employed)	Future Benefit Entitlement (000s and % of Covered)
Nonagricultural Wage and Salary Workers	88,214	49,530 56.2%	22,217 44.9%
ERISA Work Force (age 25 to 64, working 1000 hours or more, one year of tenure or more)	54,363	38,058 70.0%	20,027 52.6%

SOURCE: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS CPS pension supplement.

Table 3

Employment and Pension Coverage Among
Nonagricultural Wage and Salary Workers, 1983

	Employment (000s)	Covered as % of Employed	Group as % of all Covered
ALL WORKERS	88,214	56	100
Earnings			
Less than $10,000	25,337	32	17
$10,000-$24,999	41,211	68	59
$25,000 and over	13,741	82	24
Age			
Under 25	17,991	35	13
25 to 44	44,991	61	55
45 to 64	23,260	65	30
65 and over	1,971	35	1
Sex			
Women	40,015	53	42
Men	48,199	59	58

SOURCE: EBRI tabulations of the May 1983 EBRI/HHS CPS Pension Supplement.

Table 4

Coverage and Future Benefit Entitlement Among
Nonagricultural Wage and Salary Workers, 1983

	Covered (000s)	Entitled to Benefits as % of Covered	Group as % of all Entitled to Benefits
ALL WORKERS	49,530	45	100
Earnings			
Less than $10,000	8,180	20	8
$10,000 - $24,999	27,909	46	60
$25,000 and over	11,283	60	32
Age			
Under 25	6,376	15	4
25 to 44	27,471	42	52
45 to 64	14,992	63	42
65 and over	691	50	2
Sex			
Women	21,015	38	36
Men	28,515	50	64

SOURCE: EBRI tabulations of the May 1983 EBRI/HHS CPS Pension Supplement.

Covered Employees are Found at All Ages. Pension coverage rates are high throughout traditional full-time working years between ages 25 and 64. In 1983, 61 percent of nonagricultural workers aged 25 to 44 were covered; 65 percent of those aged 45 to 64 were covered. In contrast, the coverage rate for both workers under 25 and over 64 was 35 percent. Although coverage rates are similarly high for the two middle age groups, workers aged 25 to 44, which included most of the large baby boom cohort, accounted for 55 percent of all those covered. In contrast, workers aged 45 to 64 accounted for only 30 percent (see table 3).

As might be expected older workers, who tend to have been on the job longer than younger workers, have higher rates of benefit entitlement. Only 15 percent of covered workers under age 25 are vested, compared to 42 percent of those aged 25 to 44 and 63 percent of those aged 45 to 64. But while the vesting rate of covered workers aged 45 or more is higher than that for those under age 45, workers aged 45 or more accounted for only 44 percent of all those vested, while workers under age 45 accounted for the remaining 56 percent (see table 4).

Coverage Rates are Close for Men and Women. Fifty-nine percent of all male nonagricultural workers were covered in 1983, compared to 53 percent of all those female. Men accounted for 58 percent of covered workers; women, for the remaining 42 percent (see table 3).

Fifty percent of covered male workers were already entitled to benefits in 1983, as were 38 percent of covered female workers. Sixty-four percent of those vested were men; thirty-six percent were women (see table 4).

Coverage Rates are Higher for Those with Longer Tenure. The coverage rate of workers with long tenure is higher than that of workers with short tenure,

possibly indicating that employees will stay long longer at jobs which offer pension coverage. In 1983 only 29 percent of workers with less than one year of job tenure were covered, compared to 56 percent of those with one to nine years of tenure and 80 percent of those with ten years or more. Workers with one to nine years of tenure accounted for more than half of all those covered.

INDIVIDUAL RETIREMENT ACCOUNTS

In 1981, the Economic Recovery Tax Act (ERTA) expanded IRA eligibility to all workers (regardless of pension status) and increased the maximum allowable contribution. At the end of 1981, IRA and Keogh assets totaled just over $38 billion. At the end of April 1985, IRA and Keogh assets totaled $187.2 billion. While the total amount of assets has increased almost five-fold over the last four years, total annual contributions have been leveling off.

According to the latest Internal Revenue Service (IRS) data (see table 5), people with less than $20,000 in income accounted for 14.6 percent of total dollar deductions claimed on 1983 income tax forms. This is down from 17.0 percent of total contributions in 1981. The proportion of IRA deductions claimed by people with incomes of $50,000 or more increased from 23.4 percent in 1981 to 28.4 percent in 1983.

As a share of the total number of returns with deductions, the proportion of IRAs established in the lowest income categories dropped from 22.8 percent in 1981 to 19.4 percent in 1983, while in the highest income categories, IRAs claimed increased from 18.9 percent to 22.7 percent of total IRAs.

Who Uses IRAs

According to CPS, more than 16.7 million IRAs had been established by the end of tax year 1982 (see table 6). This meant that, assuming each

TABLE 5
IRA Usage by Taxable Income for 1981 and 1983

Taxable Income	Returns with IRA Deductions				Value of IRA Deductions			
	Number (000's)		Distribution (percent)		Amount (billions)		Distribution (percent)	
	1981	1983	1981	1983	1981	1983	1981	1983
Total	3,415	13,722	100.0	100.0	$4.8	$32.3	100.0	100.0
$0 - $19,999	782	2,658	22.8	19.4	0.8	4.7	17.0	14.6
$20,000-49,999	1,987	7,945	58.2	57.9	2.8	18.5	59.6	57.1
$50,000 and over	647	3,119	18.9	22.7	1.1	9.2	23.4	28.4

Source: Employee Benefit Research Institute tabulations based upon U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Bulletin, Vol. 2, No.3; Vol. 4, No.3 (Washington, DC: Government Printing Office, Winter 1982-83; Winter 1984-85).

Note: Numbers and percents may not add to totals due to rounding.

TABLE 6
IRA Usage by Earnings for 1982
(Civilian Employment, May 1983)

Earnings	Civilian Employment		IRA Usage		
	Number (000's)	Distribution (percent)	Number (000's)	Distribution (percent)	Within Earnings Levels (percent)
Total	98,964[a]	100.0	16,713[a]	100.0	16.9
$ 1 to $ 4,999	11,940	13.7	842	5.8	7.1
$ 5,000 to $ 9,999	16,738	19.2	1,417	9.8	8.5
$10,000 to $14,999	19,044	21.9	2,109	14.6	11.1
$15,000 to $19,999	13,644	15.7	2,366	16.3	17.3
$20,000 to $24,999	10,685	12.3	2,146	14.8	20.1
$25,000 to $29,999	5,817	6.7	1,654	11.4	28.4
$30,000 to $49,999	7,178	8.2	2,781	19.2	38.7
$50,000 and over	2,020	2.3	1,165	8.0	57.7

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS)-Pension Supplement.

Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose earnings were not reported. Those who did not report their earnings were omitted for percentage calculations.

[a]Includes those respondents who did not report their earnings.

belongs to a different individual, IRAs were used by 16.9 percent of the labor force.

Earnings groups. IRA usage increases with income. Of all people making between $15,000 and $20,000, only 17.3 percent had an IRA. In contrast, of those making $50,000 or more, 57.7 percent had an IRA. As a proportion of all those with IRAs, 46.5 percent earned less than $20,000, while 53.4 percent earned $20,000 or more.

Age Groups. IRAs are most popular among older workers. The highest usage rates for IRAs occur between ages 55 and 64, while the greatest proportion of IRAs are held by those between 45 and 54 (see table 7). Of all people between ages 55 and 64, 37.2 percent held an IRA. Of all those between 45 and 54, the proportion is 29.3 percent. Those people age 35 or over accounted for 78.6 percent of all persons holding an IRA, while those under 35 accounted for 21.3 percent.

Men and Women. Women at most earnings levels are more likely to establish IRAs than men. Among those who had earned between $15,000 and $20,000, 21.4 percent of the women established an IRA, whereas 14.8 percent of the men did so (see table 8). Of those earning $25,000 to $30,000, 35.8 percent of the women had an IRA, in contrast to 28.0 percent of the men. Men, however, who made $50,000 or over established an IRA at a rate of 59.2 percent as opposed to 51.8 percent for women in the same earnings category.

IRAs and Pension Coverage

Use of IRAs by those not covered by employer-sponsored pensions has increased substantially, but is still lower than among those with pension coverage in every earnings category. The IRS reported 3.4 million IRAs among those without employer-sponsored pensions at the end of tax year 1981.

TABLE 7
IRA Usage by Age for 1982
(Civilian Employment, May 1983)

Age	Employment		IRA Usage		
	Number (000's)	Distribution (percent)	Number (000's)	Distribution (percent)	Within Age Group (percent)
Total	98,964	100.0	16,713	100.0	16.9
Less than 25 years	19,127	19.3	445	2.7	2.3
25 to 34 years	28,773	29.1	3,108	18.6	10.8
35 to 44 years	21,484	21.7	3,967	23.7	18.5
45 to 54 years	15,493	15.7	4,532	27.1	29.3
55 to 64 years	11,218	11.3	4,169	24.9	37.2
65 years and over	2,870	2.9	491	2.9	17.1

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.
Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose age was not reported.

TABLE 8
IRA Usage by Sex and Earnings for 1982
(Nonagricultural Wage and Salary Workers, May 1983)
IRA Usage Within Earnings Levels
(percent)

Earnings	MEN (percent)	WOMEN (percent)
Total	18.5	15.2
1 to 4,999	4.4	8.8
$5,000 to 9,999	5.5	9.8
$10,000 to 14,999	7.3	14.2
$15,000 to 19,999	14.8	21.4
$20,000 to 24,999	18.4	25.4
$25,000 to 29,999	28.0	35.8
$30,000 to 49,999	38.9	43.9
$50,000 and over	59.2	51.8

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.

Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose earnings were not reported.

The May 1983 Census reported that among those not covered by employer-sponsored pensions 3.7 million people (12.1 percent) had established an IRA for tax year 1982 (see tables 9 and 10). In contrast, of the total number of IRA participants, 71.1 percent are covered by an employer-sponsored pension plan, and more than 64.9 percent of those have a vested pension right with their current employer.

Spousal IRAs

Of the 16.7 million workers who reported having IRAs in the 1983 survey, 4.0 million (20.9 percent) reported having a nonworking spouse. Of these, 2.0 million (55.7 percent) established spousal IRAs (see tables 11 and 12). The proportion of spousal IRAs among those earning $50,000 or more, at 75.6 percent, is significantly greater than among lower earnings groups. The proportion of spousal IRAs among those age 55 to 64 at 62.5 percent, is also greater than at younger ages. Employer-sponsored pension coverage appears to increase the likelihood of spousal IRA use. Among all spousal IRA holders, 76.1 percent are also covered by an employer-sponsored pension plan. Of these, 74.9 percent have vested pension rights.

Where IRAs are Invested

While the largest share of pension funds is invested in corporate equities and bonds, 63.6 percent of IRA funds were invested in banks and savings and loan institutions in 1982 (see table 13). Another 9.6 percent was invested in mutual funds and 11.4 percent was invested with brokerages. Older individuals with lower earnings were most likely to have their funds in banks and savings and loan institutions. Younger workers with high income were the most likely to invest in mutual funds. Across all age groups the highest earners were most likely to place IRAs with brokers. Younger and low wage earners tended to open IRAs with insurance companies.

TABLE 9
IRA Usage Among Workers Not Covered by Pensions
by Earnings for 1982
(Civilian Employment, May 1983)

Earnings Levels	Employment		IRA Usage		
	Number (000's)	Distribution (percent)	Number (000's)	Distribution (percent)	Within Earnings Levels (percent)
Total	30,998[a]	100.0	3,745[a]	100.0	12.1
$1 to 4,999	6,248	22.7	341	10.6	5.5
$5,000 to 9,999	7,770	28.2	520	16.2	6.7
$10,000 to 14,999	6,387	23.2	627	19.5	9.8
$15,000 to 19,999	3,113	11.3	614	19.1	19.7
$20,000 to 24,999	1,831	6.7	352	10.9	19.2
$25,000 to 29,999	1,021	3.7	303	9.4	29.7
$30,000 to 49,999	929	3.4	358	11.1	38.6
$50,000 and over	215	0.8	102	3.2	47.4

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.

Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose earnings were not reported. Those who did not report their earnings were omitted for percentage calculations.

[a]Includes those repondents who did not report their earnings.

TABLE 10
Distribution of IRA and Spousal IRA Participants
by Pension Status for 1982
(Civilian Employment, May 1983)

Pension Status	IRA Usage	Spousal IRA Usage
	Number (000's)	
	16,713	1,954
	Percent	
Covered	71.1	76.1
Vested	64.9	74.9
Not Covered	22.7	16.6
Not Known	6.2	7.4
Total	100.0	100.0

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.

Note: Numbers and percents may not add to totals due to rounding.

[a] Numbers for eligible workers are too small to infer significance.

TABLE 11
Spousal IRA Usage Among Respondents with an IRA by Earnings for 1982

Earnings	Number Eligible (000's)	Distribution (percent)	Number Contributing (000's)	Distribution (percent)	Within Earnings Levels (percent)
Total	3,504[b]	100.0	1,954[b]	100.0	55.8
$ 1 to $ 4,999	114	3.9	a	a	a
$ 5,000 to $ 9,999	172	5.9	a	a	a
$10,000 to $14,999	301	10.4	104	6.4	34.4
$15,000 to $19,999	409	14.1	205	12.6	50.0
$20,000 to $24,999	429	14.8	267	16.4	62.2
$25,000 to $29,999	359	12.4	182	11.2	50.7
$30,000 to $49,999	686	23.6	444	27.2	64.7
$50,000 and over	436	15.0	330	20.2	75.6

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.
Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose earnings were not reported. Those who did not report their earnings were omitted for percentage calculations.

[a] Numbers are too small to infer significance.
[b] Includes those respondents who did not report their earnings.

TABLE 12
Spousal IRA Usage Among Respondents with an IRA by Age for 1982

Age	Number Eligible (000's)	Distribution (percent)	Number Contributing (000's)	Distribution (percent)	Within Age Group (percent)
Total	3,504	100.0	1,954	100.0	55.8
Under 25 years	a	a	a	a	a
25 to 34 years	306	8.7	113	5.8	36.8
35 to 44 years	588	16.8	279	14.3	47.3
45 to 54 years	980	28.0	580	29.7	59.2
55 to 64 years	1,366	39.0	854	43.7	62.5
65 years and over	221	6.3	124	6.3	56.2

Source: Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.
Note: Numbers and percents may not add to totals due to rounding and exclusion of respondents whose age was not reported.
[a] Numbers are too small to infer significance.

TABLE 13
Placement of IRA Investments for 1982
(Civilian Employment, May 1983)

Financial Institution	Number of IRAs (000's)	Distribution (percent)
Banks	6,719	40.2
Savings and Loan	3,903	23.4
Mutual Funds	1,607	9.6
Broker	1,906	11.4
Insurance Firm	2,035	12.2
Other	1,298	7.8
Total	16,713[b]	100.0[b]

Source: Employee Benefit Research Institute tabulations of May 1983 EBRI/HHS Current Population Survey (CPS) Pension Supplement.

[a]Numbers are too small to infer significance.
[b]The percent distribution and the number of IRAs add up to more than the total because of the possibility of multiple responses in the survey.

HOW DO DEFINED-BENEFIT PLANS AND IRAS COMPARE?

Some of the major differences between pensions and IRAs concern their effects on saving, the inflation protection they offer, the spousal and disability protection offered, and the different groups that benefit.

Pensions as Savings for Non-savers

Employer-provided pensions are more widely distributed among households than other forms of savings. Since tax policy encourages the growth of pension coverage, therefore, it results in a progressive distribution of wealth. This redistribution can be demonstrated by comparing asset income and pension coverage data as reported by the CPS, the best available source of information on the joint distribution of pension coverage and income from savings. Direct information on savings would be preferable to the data on income from savings, but it is not available on a current basis.

According to the CPS, more than 40 percent of the labor force reported no savings income. This group's average income was $9,651, just under half the average income of those reporting some asset income. Some 55 million workers, including almost half of the group reporting little or no savings income on the CPS, were covered by employer pensions in 1983. Pensions thus constituted a net increase in savings for these workers.

Employer-provided pension coverage is also more widespread than individual retirement account (IRA) participation. Middle- and higher-income individuals were the primary beneficiaries of the broadening of IRA eligibility. An estimated 31 percent of households reporting income of $15,000 or higher hold IRA accounts, compared with 9 percent of households with incomes below $15,000.

By comparison, 43 percent of workers earning less than $15,000 are covered by employer pensions. Assessments of the value of pensions compared

with other saving should therefore consider the net increase and redistribution of wealth that results from expanded pension coverage.

Inflation Protection

A major retirement income policy concern is the erosion of pension benefits by inflation. While inflation rates have moderated in recent years, the memory of double-digit inflation is strong.

Employer-sponsored pension plans offer more comprehensive inflation protection than IRAs. During the work career, the defined-benefit plan offers inflation protection for the career employee partly because benefit accruals earned are generally related to salaries. Benefit formulas can also be designed to reflect wage inflation. After retirement, benefits can be adjusted for inflation. According to Labor Department data, about 3 percent of private-sector defined-benefit plan participants are in plans that offer systematic inflation adjustments and 51 percent are in plans that offer post-retirement increases on an ad hoc basis.

IRA contributions, in contrast, are not related to salaries because the allowable contribution is capped. IRA investment earnings can provide some inflation protection both before and after retirement. However, since most IRA deposits are invested in relatively low-earning thrift and commercial bank deposits, most IRA holders do not take advantage of the potential inflation protection that may be available in other investment instruments.

Spousal and Disability Protection

Another important policy concern in recent years, as evidenced in the passage of the Retirement Equity Act last year, is the retirement protection offered spouses of workers.

The Administration has proposed that IRAs for non-working spouses be

increased from the current limit of $250 to $2000, or the same level as that available to employed persons. This effort to generate retirement income protection for non-working spouses could help elderly women, who constitute the largest segment of the elderly in poverty. This increase, however, even if enacted, cannot provide spouses as much retirement protection as the employer-sponsored plan offers. Only a little more than half of those eligible to establish spousal IRAs do so. The majority of these workers are more affluent and older, with ten years or less until retirement. Ten years of IRA contributions and investment earnings will not provide an adequate income base for retirement, and current patterns of IRA utilization will not reach those most likely to be poor when they get old.

By contrast, the defined-benefit pension plan covers more workers over a longer period of time, generates more total retirement income, and offers universal protection for spouses of workers. Under current law, not only must all plans offer the joint and survivor benefit option, but the spouse's consent is required if the option is waived.

Disability retirement plans, which cover 91 percent of defined-benefit plan participants in medium and large firms, also offer protection for workers and their spouses that is not available through IRAs.

IRAs and Pensions Complement Each Other

IRAs and pensions fill different roles in the retirement system. IRAs provide both a supplement to employer-sponsored pensions and the added flexibility needed in an economy where employees change jobs frequently. In addition to serving as a supplement to employer plans, IRAs can be used to roll over accrued vested benefits in an employer plan on termination of service. These accruals then earn investment earnings until retirement.

Different Groups Benefit

IRAs and employer-sponsored plans are not substitutes, however. Nearly three out of four IRA holders are also covered under an employer plan; IRAs are thus not likely to fill the retirement needs of those without employer plans. IRAs offer mostly older employees a chance to supplement their retirement incomes; employer plans benefit employees of all ages.

CAN WE, AS A SOCIETY, AFFORD TO MAKE THIS AN EITHER/OR CHOICE?

The role of employer-sponsored pensions in the retirement system is long-standing and clear. These plans allow an employer, and in some plans, the employee as well, to set aside a portion of compensation on a tax-deferred basis until retirement. These plans are by law non-discriminatory, they do not compete with the employee's other expenditure needs and desires, and they provide a measure of retirement security for a workforce that by and large saves little out of current income. Employer plans cover a large and diverse segment of the workforce.

IRAs, on the other hand, are used for limited purposes by a small segment of the workforce that tends to be older and more affluent than the general population. They depend on the individual's saving plans, and thus compete for funds with other current expenditures. They offer no protection for those younger or less affluent workers that do not choose to take advantage of them, and they do not offer spousal protection for close to half of the married workers who choose to establish IRAs for themselves.

IRAs are a useful link in the retirement system, however, because they provide retirement protection for short-term or occasional workers, and because they provide pension portability between jobs.

Mr. Chairman, the Sun Company feels the country needs both.

The CHAIRMAN. Let me ask both of you, though, as we are looking at our Social Security System and looking to encourage ways of additional—I don't want to say alternative because that gives the impression we want to dump the Social Security System, and I haven't heard many people say that—but additional retirement. Are we better off to be moving toward voluntary choice by the individual? You know, this is an IRA—if you want one, fine; if you don't want one, fine. We don't have to worry about antidiscrimination rules or anything else. They are all individual choices. Are we better off to move toward that—raise the limits if we want from $2,000 to $2,500 or $3,000—and hope that great numbers of people will buy them in sufficient amounts to give them good supplementary income? Or are we better off to move toward encouraging employer-provided plans—I don't want to quite say compelling them because that is what we do with Social Security—but moving toward it with such inducements that most employers and employees would accept them, and assume that they will be much firmer, much more likely to be subscribed to, much more likely to be continued through retirement?

Mr. FERRARA. Let me suggest, Mr. Chairman, that you could, through an IRA system, create a sort of a hybrid of both that I think would satisfy the goal. And I would commend you for suggesting as a goal that we look to encouraging private sector support for retirement income as a means for expanding retirement income in the future. But if you take the IRA system and you raise the maximum limit from $2,000 a year to maybe $5,000 a year per spouse, and then you make a modification where you allow the employer to contribute to the worker's IRA, rather than the worker, so that instead of the worker putting in the $5,000, the employer could choose to put in the $5,000, you would get the benefits.

The CHAIRMAN. And that would be put in and not counted as income—current income—to the employee?

Mr. FERRARA. Right. That is right.

The CHAIRMAN. And still be a deduction to the employer at the time of putting it in?

Mr. FERRARA. That is right. The employer would get the deduction, and that kind of combines the function of IRA's and employer-sponsored savings plans—you would increase participation by lower income workers by doing that. You would allow employers to perform the same function as they do today. There is an advantage in employer-sponsored savings plans in that they might get workers to participate who wouldn't think of it on their own or wouldn't bother on their own. And by combining the two systems in this hybrid fashion, you would have this benefit of getting the employer participation and the employee participation, plus you would have this tax theory benefit in that if you have a contribution on, say, $5,000 per spouse, for most of the people in America, they are in effect going to be under a consumed income tax, as most families are not likely to save more than $10,000 in a year, anyway. And so, you have got the advantage of giving them the proper and maximum incentives for savings and investment, at the same time you are serving an important retirement policy function. So, it is a justifiable retirement and tax policy as well.

The CHAIRMAN. What is the advantage to the employer? The employee has an IRA and the employer puts up $2,000, $3,000, $5,000 a year, or $10,000 if you can put it up for your spouse—nonworking spouse also. The employee puts this up for 5 or 10 years and then the employee leaves. Where is the employer's advantage?

Mr. FERRARA. This employer would have the same incentive that he has to do sponsored savings plans today and pensions today. I guess your question implied that the employer won't be able to use the IRA system to tie the worker to the firm.

The CHAIRMAN. That is what I am saying. Yes.

Mr. FERRARA. But I don't know that you want to do that. That has a negative effect on the economy. It reduces labor mobility. It has the effect of an employer using the retirement policy to satisfy employer goals rather than the employee's goals, and I would suggest that the IRA's maximize the freedom of the worker to pursue his own goals, rather than having the employer restricting his options, trying to bribe him into being tied to a firm that he doesn't—might not want to stay with any longer; and it reduces labor mobility, and it is bad for the economy.

The CHAIRMAN. Mr. Smith.

Mr. SMITH. I hear Mr. Ferrara saying perhaps two things. One of them is if you take an IRA and amend it to be a semi-401(k), it will work. I think it would, but IRA itself as it now exists has some flaws in it, and one flaw has to do with human beings. People aren't saving, and the statistics show that pretty clearly. So, when they are older and unable to fend for themselves, what do we do with them? Up North, they used to put them on ice floes and ship them out to sea. There aren't any that big to take care of the millions of Americans that will not be able to fend for themselves when the time comes. I think as a matter of public policy, we have to be pragmatic and say that some people will be unable to fend for themselves, for whatever reasons, and we must help. And the voluntaristic system will not work. So, if you make the laws more favorable to employer-sponsored plans, the statistics show that they are far more successful in terms of participation.

The CHAIRMAN. I want to come back now to Mr. Ferrara. You are suggesting basically that when the employer puts his money into the IRA, it is investing total portability and that the employer would be interested in that.

Mr. FERRARA. The employer ought to be interested in that because of the way it would be attractive to his workers. His workers will say great, I can get this good compensation deal, this great retirement package, if I go to this employer over here. And this employer over here is not forcing me to give up my labor mobility to get a retirement plan, and they would prefer that. And that could be an inducement to bring employees into the firm, and so that is the advantage to the employer, plus it is a form of giving workers compensation that has a good tax treatment. So, then, workers would say gee, that is good. If I work there, I can get my compensation in a good tax treatment form, so they would be attracted as well. So it would help employers to attract workers. Without giving employers the opportunity to take over the retirement policy of workers to suit the employers goals, rather than the employees goals.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Ferrara, I just want to say, as far as one Senator goes in this panel, that I disagree with your proposal on page 9 that the IRA contribution limit should be indexed. The rationale you give is that everything else is indexed, so why not IRA's. If you follow that philosophy, you can reach the goal you reach, but I just think all indexing is bad period. We are going to end up like Israel around here if we keep up this indexing. I won't balame you for that. All you said was that everything else is indexed, so let mine be indexed, too.

Second, I am not quite sure that I follow what you are saying. If you have this increase in IRA that the employer contributes in lieu of the pension or possibly supplementing the pension and the employee gets it, then the employee is free to dip into that IRA under the limited conditions that you set forth. Wouldn't that be true?

Mr. FERRARA. Yes, that would be true.

Senator CHAFEE. For buying a principal residence, college eduction, and unemployment?

Mr. FERRARA. But then it would be included in as income. So, it is analogous to employer-sponsored savings plans. I mean, under many of those plans. Like 401(k)'s, there are circumstances under which the worker can withdraw it as well. So, if the worker withdraws it—once he withdraws it—it becomes like his regular income, and it is treated like normal income and is included in any tax on it. So, I think that that is——

Senator CHAFEE. But what do you say to Mr. Smith's point that what we are trying to do under retirement programs is to have something available for retirement? I am not sure we should always act as big brother around here and say what people can or can't do with their money, but clearly, that money under certain circumstances just plain wouldn't be there for retirement.

Mr. FERRARA. If you think that that is a big problem, I would prefer to allow workers the maximum freedom to plan for their own futures and just choose things that they need to spend their money on. And I think it is a good system the way I proposed it because workers only get the tax-preferred benefits as long as they allow it to be saved. Once they withdraw it, then they no longer get the tax preferred benefit, and that is good enough the way it is. But if that doesn't satisfy you, you could put a higher withdrawal penalty on portions of the IRA that are attributable to employer contributions than on the employees' own contributions. That would be a potential solution to the problem you raise, but I would rather not do it that way.

Senator CHAFEE. I see. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. In the debate that I have heard on this issue in the few meetings I have held in my State, it hasn't tended to, for the future, either point of view that you gentlemen take, that there wouldn't be any disagreement. The discussion just hasn't been on that. The discussion I have heard is the extent to which, whatever our tax policy is, you know, whatever it was and people made plans on retirement systems, that that money could be used, borrowed on, or used short term, and then that tax policy has been changed in the past. Whether or not we should not make our changes just

for the future and not affect plans that people have made in the past, and the tax policy has changed that and detrimentally affected people who have put money into these retirement plans. So, my question to you would be: Are you talking about changes that ought to be made for the future or would you affect those plans that are already in place, money that is already in those plans, that people previously had thought should be borrowed on, and if there was a change in the law, they would not be able to borrow on?

Mr. FERRARA. I didn't come here, Senator, to make a proposal. I came to debate the virtues of IRA's versus pensions, although I do suggest that I support the President's proposals, primarily as is, and would affect things in the future to the extent that—versus things that are already in place, to the extent that—he does in that proposal. And I think if you look at the pension provisions in that proposal, I believe that they structured them with awareness that pensions must be maintained with strong, viable options, and the proposals do that. They don't harm existing plans. What they do is eliminate abuses and they adopt a set of reforms that ought to be adopted in any event, for the most part, except that I think they go too far when they increase the withdrawal penalties for employer-sponsored savings plans and also when they increase them for IRA's.

So, I would suggest that, because their proposals are sensible and are not going to damage those plans but provide reasonable reforms, that they ought to be adopted as is, even to the extent that they affect already existing plans. I would like to add in addition to that—I don't want to be misinterpreted in what I am saying here. I am not saying no pensions. Pensions are important, and it is in my prepared statement and it was in my comments; that both pensions and IRA's are important to create a maximally viable private system, to induce the maximum number of people to put money forth for retirement support through the private sector rather than through the Government. And we have got to maintain both of those as viable as possible.

In terms of the future, pensions are already to the point where they have been around for 60 years and they have reached a good point. The administration doesn't cut them back unnecessarily. And if we are going to talk about expansion for the future, the opportunity in that lies in the area of IRA's, which is a relatively new system and which has a lot of opportunity for being expanded in very useful and meaningful ways that can induce many more people to set aside private support for their retirement in the future.

Senator GRASSLEY. I would just like to suggest that, from my standpoint, money that has been saved up to a point where the law has been changed, and there might be increased penalty, that it ought to be applicable for the additional saving or the entrance into a new plan in the future, but that we should not change the rules in the middle of the game for those people who have already saved, counting on the ability to withdraw or borrow without penalty, or at least those penalties should not be increased.

Mr. FERRARA. What I suggested was that those withdrawal penalties are bad for future plans as well as existing plans. They shouldn't be involved in either case.

Senator GRASSLEY. I don't want to disagree with you. I am just saying that the problems I have had posed to me is not what people are suggesting the bill might do to them in the future but what past changes have done or what the existing plan would change for plans that they are already in, and that they would not feel badly about new rules for new saving, but that they resent it. And I think it is punitive to have new rules for old plans.

Mr. SMITH. I would like to say that to do other than what Senator Grassley suggests would be disastrous for people approaching retirement, absolutely disastrous. The plans would be, you know, of no avail.

Senator GRASSLEY. I don't see that at all.

Mr. SMITH. To do otherwise, other than you suggest—you suggested that the changes be made prospectively rather than retroactively, and I am just agreeing with you. Those nearing retirement would have terrible difficulty if the new tax rules are made retroactive.

Senator GRASSLEY. We are talking mostly about penalties.

Mr. SMITH. Yes.

Senator GRASSLEY. If you were to borrow money from a plan.

Mr. SMITH. Oh, I see what you mean now.

Senator GRASSLEY. Yes. If you put money into a plan and you were planning on using for your kids to go to college?

Mr. SMITH. OK. Excuse me.

Senator GRASSLEY. That is what I am referring to. Would that be disastrous?

Mr. SMITH. No. No; it would not.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. The first question poses kind of a threshold question, and that is: Should the tax system be used to promote particular kinds of savings? Since 1981, IRA's have increased dramatically. Do you have any idea of how much the IRA's are worth today?

Mr. SMITH. About $160 billion—billion.

Senator BRADLEY. $160 billion?

Mr. SMITH. Right. Yes.

Senator BRADLEY. So, $160 billion in discretionary savings has gone into IRA's since 1981?

Mr. SMITH. Well, IRA's became legalized in 1974, Senator.

Senator BRADLEY. All right.

Mr. FERRARA. They were much more narrow before 1981.

Mr. SMITH. The boom was from 1981.

Senator BRADLEY. Where did that savings come from?

Mr. SMITH. Primarily from the more affluent and the older, not from the less affluent and the younger.

Senator BRADLEY. Well, that is one way to look at it. It came from primarily those who had excess income, and the wealthier you are, the more excess income you have. That is not really my question. Where did the savings come from? Did it come from people making more money, or did it come from them taking money out of one place and putting it in another?

Mr. SMITH. Let me try to answer that. I did say a few minutes ago that 58 percent of IRA holders are people earning $50,000 and over.

The CHAIRMAN. Now, wait a minute. What is that figure again?

Mr. SMITH. Some 58 percent of the nonagricultural workers who are earning $50,000 and over, Senator, hold IRA's, and I think two-thirds of those also participate in other types of pension plans.

Mr. FERRARA. Let me try and answer the question.

The CHAIRMAN. Now, wait a minute. I want to get that statistic, if I can, because I have a totally different statistic from what Mr. Smith is citing. You were saying that 50 percent of the number of IRA holders or the quantity of money in IRA's or what?

Mr. SMITH. The individual participants, sir, not the money. I don't know about the money.

Mr. FERRARA. He is saying 58 percent of people earning more than that amount a year have IRA's, but what I am going to say is that is not the way to look at it. What you have got to look at is the income distribution of people who own IRA's, versus the income distribution of people who are covered by pensions. And what you find when you do that is they are not that different, that in fact if you look at workers under $20,000 in income, 40 percent of IRA participants are workers with under $20,000 in income, compared to 51 percent for pensions. If you look at workers under $10,000 in income, 13.5 percent of IRA participants. If you look at all people who have IRA's, 13.5 percent of them earn less than $10,000 compared to——

Senator BRADLEY. That is an interesting answer, but it is not my question.

Mr. FERRARA. I know, but that question was raised by the answer.

Senator BRADLEY. I understand you might anticipate that that is a question that might be asked, but I didn't ask that question.

Mr. FERRARA. All right. Let me try and answer your question now. Since he had one shot at it, let me have a shot at it. A lot of people like to throw around potential answers to that question. There is nobody who tells you he does is selling you a line. Now, what we have on the face of it is $160 billion in savings put in IRA's. Now, the question is: Is that a rollover of savings people already have, or did the good treatment of savings induced by, or offered by, IRA's induce new savings that wouldn't have occurred otherwise? My inclination is to believe that it has induced new savings, but there is nobody, I think, who has produced any study that clearly demonstrates that, one way or another. All you have on the face of it is $160 billion of savings in IRA's. That is a lot of savings. At least some of that has got to be new savings, and that is a lot of new savings to have generated.

Senator BRADLEY. What is the national savings rate?

Mr. FERRARA. Some 5 or 6 percent, something like that.

Senator BRADLEY. And has it changed much in the last 30 years? The answer is no.

Mr. FERRARA. That is right. It hasn't changed much in the last 30 years.

Senator BRADLEY. So, can you then assert that there has been a dramatic increase in savings?

Mr. FERRARA. We have only had IRA's for 4 years of the past 30 years. So, give the thing a chance.

Senator BRADLEY. Another $160 billion? Wait until it gets to $320 or $400?

Mr. FERRARA. Well, that is all savings, and we like that, Senator.

Senator BRADLEY. My point is that the question here that the chairman has posed for each of you is: Will specific tax incentives increase particular kinds of savings? And I think that you would have to say yes, certainly, but the real question is: Does it result in a net increase in savings? Because if it does not, you are simply giving people an incentive to take money out of an interest-bearing savings account that is yielding interest that can be taxed at 50 percent and put it in a tax-free account. Or you have people with money invested in equities that would be taxed at 20 percent and putting it in a tax-free account. Is that not correct, Mr. Smith?

Mr. SMITH. I have to agree. My best information is just a guess, and that is that the more affluent probably are saving a little more, but it didn't change the 5-percent national savings rate.

Mr. FERRARA. No; IRA's are too small of a program to have it show up in the national savings rate.

Senator BRADLEY. That was my next question.

Mr. FERRARA. You have got to expand IRA's to have them affect national savings.

Senator BRADLEY. Right. Then, that would clearly be where your argument would lead. Don't just limit it to $2,500; put it at $10,000, or $20,000.

Mr. FERRARA. That is what I said, and that is in my written testimony. That is what it says. Put it at $10,000. That is right.

Senator BRADLEY. $10,000? How much do you think that would cost?

Mr. FERRARA. You know, Senator, many tax theorists believe that all investment ought to be taxed the way IRA's are anyway. The Hall-Rabuska tax reform proposal, which I am sure you are familiar with, would tax all investment the way IRA's are taxed. Your colleague, Dennis DeConcini, has introduced a bill involving the Hall-Rabuska tax proposal. They have a 19-percent flat rate across the board in a revenue neutral proposal in which all investment is taxed the same way IRA investment is. So, it is not an infeasible thing. Treasury I, the first Treasury reform proposal, suggested that treating the tax investment that way, under a consumed income tax system, because treating all investments like IRA's would create a consumed tax system, the Treasury I said that that ultimately was the ideal. And what they suggested was that you should try and set the maximum IRA contribution limit high enough so that all Americans, in effect, would be under a consumed tax system because the limit would be as high as any amount of savings most people are likely to do.

Senator BRADLEY. Mr. Ferrara, I am sure that there isn't a member of this committee that wouldn't agree with you that, if given the choice, the American people would prefer to pay no tax, but that is not the exercise that we are engaged in here. We are trying to think through a tax reform proposal that is guided by certain criteria, not the least of which is you don't want to increase the deficit. So, if you increase an IRA deduction to $10,000, as you

recommended, you have got to get the money somewhere else. Or if you raise the IRA to $10,000, you have suddenly skewed the distribution so you again have to raise the rates. And the question is: What is the proper balance? And you know, I can understand that you would come in and make the argument as you have, well and aggressively, and I appreciate that. But I think that there are other issues that we have to look at here.

Mr. FERRARA. Let me just say, Senator, that in my testimony I suggest that the $10,000 IRA limit not be something in this tax reform bill, that this ought to be a long-term goal, and that I recommend some specific minor adjustments to the IRA system, such as indexing the——

Senator BRADLEY. So, would you say that we shouldn't even contemplate increasing the IRA until the budget is balanced?

Mr. FERRARA. No; I wouldn't say that. I would agree that this tax reform bill ought to be a revenue-neutral bill and that besides the elements of the President's proposal, only minor additional elements could be made at this time. But that as a long-term goal, IRA's ought to be expanded when that is feasible.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Let me ask this of Mr. Ferrara. In going all out for IRA's, as you are, why not permit a carryforward? In other words, if a person doesn't use the maximum in a year, he can carry that forward to a future year and then, when he comes into some money, can go ahead and make that contribution in a subsequent year?

Mr. FERRARA. I think that is a great idea, and I would endorse you 100 percent. I think that is a good idea.

Senator CHAFEE. I thought you would say that. [Laughter.]

Next, Mr. Ferrara, in Mr. Smith's statement on page 10, he states: According to the latest IRS data, people with less than $20,000 in income, account for 14.6 percent of the total dollar deductions. You have another figure about how many people of less than $20,000 contribute, I think that we all know that the people with less than $20,000 have a tough job coming up with making a significant contribution, it indeed they make any, to an IRA. Would you agree with that?

Mr. FERRARA. To an extent, I would agree with that.

Senator CHAFEE. So, therefore, if a company has a 401(k) plan, it seems to me the strict nondiscrimination features of it permit the employer to encourage the employee to participate. Would you agree with that?

Mr. FERRARA. The nondiscrimination provisions in the 401(k) plans? Well, they have effects both ways in that, by being restrictions in their natural nature, they tend to discourage people from setting up such plans. I mean, they are a disincentive to setting up the plan in the first place. And so, there are effects both ways. The restriction itself encourages the employer to get more people to participate in the plan, on the other hand; but on the other hand, just having the restriction discourages the employer from even trying in the first place.

Senator CHAFEE. What do you say to that, Mr. Smith?

Mr. SMITH. When you introduce a 401(k) under the nondiscrimination rules, every effort is made to encourage everybody to go

into it. Sun Co., for example, in our experience, our savings plan had dropped down to the low of 60 percent participation. With the 401(k), it jumped to 83 and is still going up. And it is self-interest; it is the promotional program you put on. Of course, it works. It works everywhere.

Senator CHAFEE. So, therefore, wouldn't one proposal be to have high 401(k) limits instead of high IRA limits?

Mr. SMITH. That would be my position. Yes.

Mr. FERRARA. What I would say to that is that the problem is that 401(k)'s are only available to workers who happen to work for employers who have set up such a system, whereas IRA's are universally available, so the expansion should occur in IRA's. Now, what you could do, as we talked about a minute ago, is allow the employer to contribute to the IRA. If you want, you could apply the nondiscrimination rules to the employer. If he contributes to one employee's IRA, he has to contribute to others, or leave the plan open to all workers or whatever.

Senator CHAFEE. Yes. Of course, that is an expensive proposal, though, as far as the Federal Treasury goes.

Mr. FERRARA. It depends on how much you allow. You might put a restriction on it in the beginning. You might say the employer can only contribute up to $500. Also, you have a—You can do this without increasing the maximum limit. You can say the limit is $2,000 a year on IRA's, but either the employee can put the money in or the employer can put the money in, and the deduction happens either way. Now, that will increase your participation rate, and you will lose some revenue because of that, but I think that we need to look at it closely to see what the revenue loss would be because of that. If you can do it without increasing the maximum limit, and if you do that, the only way you are going to lose extra revenue is by increased participation, and that revenue loss may not be that great.

Senator CHAFEE. All right. Fine. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. No questions, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I would just like to come back to this suggestion that we dramatically increase the IRA's and simply leave the issue with the thought that, if you are not going to increase the deficit and you dramatically increase the amount that you can contribute to an IRA, it is predictable that the result is going to be a higher tax rate on labor, clear and simple. And so, what you are saying, when you argue for a dramatic increase in the IRA, is that families whose income is derived from wages and who are barely making ends meet are going to be faced with a higher tax rate. And I wonder if that is really the direction the committee wants to go. I think that the whole thrust of tax reform is to say to America's working families that, if we are able to eliminate a lot of the special provisions in the Code, they will get a lower tax rate. And that means if they earn more, they will keep more. If you dramatically increase these special savings

provisions, if they earn more they will keep less because tax rates will be higher. And I don't think that is what we want to do.

Mr. FERRARA. Let me just say, in response to that, that——

Senator BRADLEY. Mr. Smith.

Mr. SMITH. At the risk of alienating some of my colleagues and perhaps some of you, but as an American citizen concerned with this deficit also, why not limit IRA's, and don't let poeple have them that have the 401(k) plus, a defined benefit plan? Put the IRA's where they are needed. Sure, IRA's are needed, but they are not needed in my view where duplication exists—take my own case. I have 401(k), a defined benefits plan, and that is enough. Now, if you want to get selective and work on the budget and go back to the basics of benefit programs, take a look at the duplication. Take a look at all the fancy new things we have added in recent years in response to new tax laws. Consultants—geniuses, many of them—can come in with more ideas on how to circumvent the tax rules, build up greater equity, and this is good. But now, we are faced with a budget deficit, and if we really want to work at it, then take a look at how to trim benefits back some. It is a lush program. We have many benefits. Let's make sure we don't hurt the ones who need it the most. Thank you.

Mr. FERRARA. I would like to say that, as you get to know me, Senator, you will know I do not favor higher tax rates on anybody, lower income workers or higher income workers, at all. And I think that the logic of what you are saying implies that we should impose harsh, discriminatory taxation on investment so that we can lower tax rates on labor, and I don't——

Senator BRADLEY. I don't think that 30 percent is an abusive tax rate. Do you think that 30 percent is an abusive tax rate?

Mr. FERRARA. I think 30 percent is a good goal for a tax rate, but under a tax system—but not when you tax the investment two or three times, like you do under our tax system as opposed to the alternative consumed income tax system which you have with the IRA system. The problem is not just the rate. The problem is that under our tax system we tax investment two or three times, and that to me is unfair and discriminatory. And the IRA system is meant to eliminate that multiple taxation of investment, and that is why many tax theorists say that that is the only fair or neutral way to tax investment across the board. And it is bad for workers to be crippling investment in this country where they need the investment to create the jobs and create the investment which provides the increase in their income in the future by giving them the capital goods by which they can be more productive. So, I think it doesn't serve much purpose to talk about labor versus capital. What you need is to have a fair tax system for both, and that is the most beneficial to everybody, including workers.

Senator BRADLEY. Well, I think that everybody on the committee would be for the lowest possible tax rate, the retention of this big IRA and other special benefits, and a balanced budget. I am not sure we can do all three. The question is: How do you make your choices, and I think that is really what the committee is trying to decide.

Mr. FERRARA. Let me just say this: You talked about a 30 percent tax rate, Senator, and let me just reemphasize that under the Hall-

Rabushka plan that was introduced by Senator DeConcini, you have a 19 percent tax rate and all investment is treated as an IRA. So, it is not necessarily impossible. I am not saying that his plan is perfect or that plan is any more perfect than anybody else', but I just raise that by way of showing that this approach is feasible.

Senator BRADLEY. Does Hall-Rabushka also have an inheritance tax?

Mr. FERRARA. I don't know if it has an inheritance tax or not.

Senator BRADLEY. All right. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. It seems to me we need to keep in mind that we don't have all the answers. We are still looking for them. Every now and then, when we try something, it does not work. I really think that those of us who serve on these committees ought to have the courage, when something is not working, to let it expire or to repeal it. But that shouldn't keep us from experimenting with new ideas.

While I think the IRA's have a lot of merit to encourage savings, the thing that bothers me about relying so heavily on that provision to the exclusion of other things, is that the families that we really need to be thinking about are never going to have any savings because they have a child who needs new shoes and the wife needs a new dress, and with one thing and another, they just don't put the money aside. Please understand that I think there is a lot of merit to encouraging savings in IRA's, but I think there is also a place for employee stock ownership plans where the money that goes in there is almost like a spendthrift trust. You can't get your money unless you leave the job. As long as you are with the company, the money is in that employee stock ownership plan, and generally speaking, the idea is that you can't get it until such time as you retire. Now, of course, at that point you can have your money and do whatever you want with it. What is your thought about that, Mr. Ferrara?

Mr. FERRARA. Yes. First, let me say that I am not saying we should have IRA's to the exclusion of other things. As I said in my written statement, both pension and IRA's are necessary. There are people who won't participate in IRA's who could be induced to participate in pensions, and I have both as part of a comprehensive tax system. I also think the employee stock ownership plans are a very good idea as well. In order to increase participation, there are many good ways that I also suggest in my testimony to increase participation by lower income employees in IRA's, one being, as I discussed with Senator Chafee, allowing the employer to contribute to the IRA in lieu of the employee's contribution. And that would be kind of like a merger between employer savings plans and IRA systems. Another thing I mentioned in my testimony——

Senator LONG. Tell me again how you would do that. I am not sure I understand.

Mr. FERRARA. You could say you have a maximum limit of contributions to IRA's each year of $2,000. Now, under the current law, the employee can contribute. What you could say is that you will allow the employer of that employee to contribute to the employee's IRA, rather than the employee. And that may be a way of getting around the constant temptation not to save and, like you

say, spend it on a new dress or whatever. The employer might be able to induce employees to be more willing to save. Another suggestion in the written testimony was that which is a feature in the Bradley-Gephardt tax plan, which has all deductions taken against a single flat rate, and that provides the same incentive across the board to participate in IRA's at all income levels, and I think that is a desirable feature. And that is in the Bradley-Gephardt plan, and it is in the Kemp-Kasten plan, and I think that equalizes the incentives and would serve to increase relative participation by lower income workers in IRA's as well. So, I think you need to take more approaches than just the IRA's. You need a comprehensive system, and you can make modifications to IRA's to improve participation by lower income people, but also, I would note again that the income distribution of people who participate in IRA's is not that different from the income distribution of those covered by pensions.

Senator LONG. What is your thought, Mr. Smith?

Mr. SMITH. To repeat, I think the defined benefit plan is the linch pin of the public system and the private system, that IRA's by definition, by usage, with the way they have grown, has a limited use. It is a peripheral plan, a supplemental plan. It is no way ever to be a substitute for the defined benefits plan, nor in any way, in my judgment, will it ever be a pension plan itself. There is just not enough inducement for lower paid people to participate.

The CHAIRMAN. Any other questions?

[No response.]

The CHAIRMAN. Gentlemen, thank you very much.

Mr. FERRARA. Thank you very much.

Mr. SMITH. Thank you, sir.

The CHAIRMAN. Next, let's move on to a panel of Dr. Daniel Halperin and Mr. John Thompson. This is issue No. II, and the issue is: The current tax code gives special tax treatment for qualified retirement plans, such as not currently taxing investment income earned by the plan and not counting as current income the funding of retirement benefits for employees. Should these tax advantages be denied to savings arrangements that allow loans or use of the funds before retirement age? Speaking in the affirmative on that, first, will be Dr. Halperin, and in the negative, Dr. Thompson. Dr. Halperin, go right ahead.

STATEMENT OF DANIEL I. HALPERIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Mr. HALPERIN. Thank you, Mr. Chairman. The issue before us is under what circumstances is the special tax treatment now given to qualified plans justified? Is it just for retirement savings, or is it for savings for other purposes as well? I think it is important to recognize that we are looking at this in the context of an income tax. We heard a lot of discussion this morning about whether a consumption tax might be better, but it seems to me that the focus of this hearing is, given that we are going to continue with income taxation, do we still want special treatment for certain kinds of savings, which in effect exempts the income from those savings

from tax? If we carry that all the way across the board, of course, we no longer have an income tax.

The decision has been made nevertheless that we need Government involvement in providing retirement income. We have the Social Security system, which is a clear indication of that. Possible reasons would be that it is a long-term horizon for saving. You are saving for something that is going to happen 30 or 40 years in the future. There are many, many uncertainties. It is very difficult for individuals to think about how much they will need when they retire. Savings for retirement are qualitatively different than savings for any other purpose. That justifies Social Security, but Social Security alone is not sufficient for full replacement of preretirement income, and therefore, we have made the decision to help people beyond Social Security by providing tax incentives for employer-sponsored plans.

As we have heard this morning, and I believe strongly, the difference between employer-sponsored plans and individual savings arrangements like IRA's is the forced active participation and benefits for low-income individuals. The opportunity for these people to participate in the plan is not sufficient. Everyone has an opportunity to participate with an IRA. It is actual benefits at retirement that counts. To summarize, then, it must be the extraordinary difficulty of planning for retirement that justifies Government aid in the form of Social Security and the tax incentives for private savings. Tax incentives would be ineffective if directed at the individual. They are appropriate, if at all, only for employer-sponsored plans which actually provide significant retirement income for low- and moderate-income employees.

And that focuses the question on whether we should allow these plans to make preretirement distributions. I think in a perfect world it would be best to prohibit distributions prior to retirement, or at least prior to a certain age, such as age 60. That is the present rule for pension plans. From section 401(k) plans, distributions prior to age 59½ are permitted only in the case of hardship. However, from regular profit-sharing plans, distributions are permitted at any point. It would be best, I think, if we could have a uniform rule which would disallow preretirement distributions. But there is a dilemma. Even if we recognize that the goal is retirement savings, there is a problem. People say that certain individuals will not go into the plan if they know they cannot get the money until retirement is reached. It is also very hard to say to people who have pressing needs that there is that fund out there and, if you could only manage to live another 20 years, it is yours; but in the meantime, there is no way you can get your hands on it. Therefore, I recognize that we may have to permit withdrawal under certain circumstances, but the purpose of permitting withdrawals is to encourage people to go into the plan. It is not to affirmatively allow them to save for other purposes.

The CHAIRMAN. Say that again.

Mr. HALPERIN. I am saying that if we do allow withdrawals, we must remember that we are allowing it because we believe, in the long run, that encourages people to save, and more money will actually be there for retirement, not because we think that they ought to be allowed to use the retirement vehicle for other pur-

poses. For example, certain things like special averaging for lump-sum distributions which encourage early withdrawals have no place in the system. And the administration proposal to repeal it is quite justified.

If we are going to allow withdrawals prior to retirement, I think it would be better if we could limit them to unforeseeable emergencies, like medical expenses or unemployment, not for college tuition or for purchase of a home which people can anticipate. If it become necessary to expand the circumtance in which withdrawal is permitted again, in order to encourage people to get into the plan in the first place, then at least in cases where there is no emergency—where people are using money for anticipated purposes, we need to recapture the benefit of the qualified plan so they are not encouraged to use the plan for savings for other purposes.

The present law attempts to do that by a 10-percent excise tax on early withdrawals in certain circumstances. The administration would expand those circumstances and increase the tax to 20 percent unless the withdrawal is for particular purposes.

I think the tax is defective. The benefit to a particular individual depends upon three things: His rate of return, the length of time the money is in the plan, and the tax rates to which he is subject. A 10-percent excise tax is like a watch that has stopped. It is only right once a day. We need to have an excise tax which is more directed to the particular benefits. In particular, we ought to relate it to the individual's tax bracket. A flat 10-percent tax across the board is much more detrimental to the lower income people. If the point is that lower income people will not go into the plan unless they know they can get the money out, then they have to be able to get it out without a harsh penalty and a penalty which is very harsh on them doesn't do the job. If the penalty is not too harsh or low income then it is too small for the high income people. They can affirmatively and consciously use the vehicles for short-term savings. The low income people realize that they cannot.

If I could just say one more point. I think loans should also be prohibited for similar reasons. If we are going to allow loans as opposed to withdrawals, it is because we think they will be repaid and therefore be available for retirement. We need to do more to require that. It is now possible to keep the loan going forever by just repaying it for 5 minutes and then reborrowing. The administration would try to prevent that. And second, I think it is most important to disallow interest deductions when people borrow for retirement savings.

The CHAIRMAN. I have to ask you to wrap up, though, because we are holding our witnesses down today.

Mr. HALPERIN. OK. I just want to say allowing an interest deduction for borrowing for retirement savings is not valid because it allows people to continue to benefit from qualified plans even though there is no savings. Just to sum up, I suggest that we should prohibit early withdrawals if we can. We should allow it only where evidence shows it will actually increase retirement savings. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Now, Mr. Thompson, who is the chairman and chief executive officer of the Southland Corp. Mr. Thompson.

[The prepared written statement of Dr. Halperin follows:]

STATEMENT OF DANIEL I. HALPERIN

BEFORE THE

SENATE COMMITTEE ON FINANCE

Tax Reform Hearings

Retirement Arrangements

July 11, 1985

Mr. Chairman and Members of the Committee:

My name is Daniel Halperin. I am a Professor at Georgetown University Law Center and I have previously served as Deputy Assistant Secretary for Tax Policy. I have been involved in the area of Employee Benefits for more than 20 years - in private practice, in the Treasury and in teaching - and have frequently written and spoken on the subject. I appear today on my own and not on behalf of any client or organization.

It is my opinion that the special tax incentives for qualified pension and profit sharing plans should be directed toward savings for retirement and should not be available to other forms of savings. I strongly support the Administration's initiatives in that direction as well as its efforts to improve the distribution of tax - favored savings - more to the low and moderate income worker and

less to the affluent. I oppose any expansion of the IRA; to do so is clearly inconsistent with the other proposals advanced by the President.

Justification for Special Treatment

An income tax applies to income from capital as well as income from labor. A consumption tax effectively taxes only labor income; earnings on investments are effectively free of tax. We have an income tax. The President recommends strengthening that tax and halting the tendency towards the consumption perspective. I assume this approach is accepted for the purpose of this hearing. (We are not here arguing about whether a consumption tax would be better.) Nevertheless, qualified pension and profit sharing plans receive consumption tax treatment. Amounts contributed to such plan compound at a pre-tax rate of return while savings in other forms earn only an after-tax rate.

How can this difference be justified? What distinguishes retirement savings from savings for other purposes? The existence of Social Security suggests a distinction. Presumably, it is the difficulty of anticipating many years in advance what one's needs will be in retirement. Further since we cannot be sure whether we will live to retirement or how long thereafter, it makes sense to pool the mortality risk as most of us do in the

case of life insurance. In terms of both the length of the planning period and uncertainty, this is qualitatively different than even savings for college tuition or purchase of an initial residence.

Social Security is not designed to fully replace pre-retirement income even for low and moderate earners (except perhaps for low wage one-earner families). To save more or not could be left to individual choice but it has been determined to influence that choice by providing a tax incentive for retirement savings.

But it is important to recognize the potential perverse nature of that tax incentive. It provides the largest benefits to the high bracket individuals who are most likely to save in any event. For the lower paid who need the biggest push, the incentive is considerably smaller. Comparative utilization of IRAs by income class illustrates that a tax incentive directed to individuals will not significantly increase retirement savings for the lower income. See for example, Report of the President's Commission on Pension Policy 35 (1981).

The saving grace is the non-discrimination test. If the high paid wish to take advantage of the tax break, they must make certain that the low paid participate as well. This is the premise that makes employer sponsored plans superior to

IRAs. The premise also explains the importance to the concept of non-discrimination of actual participation and retirement benefits for the lower paid not simply opportunity to participate.

To summarize, it must be the extraordinary difficulty of planning for retirement that justifies government aid in the form of the Social Security program and the tax incentives for private savings. Tax incentives would be ineffective if directed at the individual. They are appropriate, if at all, only for employer sponsored plans which actually provide significant retirement income for low and moderate income employees.

Therefore, the tax incentive should be limited to the extent feasible to plans which provide periodic retirmenet income to employees. No tax incentives should be granted to plans which are limited to highly paid individuals. The tax benefits for IRAs should be curtailed if at all possible; expansion is totally unjustified. The more difficult question is the appropriate treatment of plans which provide employees with a choice but which nevertheless can be said to provide non-discriminatory benefits. Before turning to that issue, I want to say a brief word about my image of the ideal plan consistent with the purpose of the tax benefits.

Defined Benefit-Defined Contribution

Ideally the employer plan would provide employees with a benefit which together with Social Security would provide a specified percentage of pre-retirement pay, adjusted for the cost of living. The employee knows what will be available from the plan in relation to his current standard of living and is relieved of the risk of investment.

This type of plan, so-called defined benefit, still predominates. But, perhaps, in part due to the greater regulatory burden imposed on defined benefit plans since 1974, some report an increasing trend towards so-called defined contribution plans. The employer makes a contribution; the benefit depends upon investment performance. Many of these plans are not established with a particular retirement income level in mind or if there is one, it may not be communicated to employees. If there is an income goal, achievement depends upon the accuracy of the projections as to investment performance and salary growth and, particularly if there is a choice as to the level of contributions, the accuracy of that assumption. Further there is often no sharing of the mortality risk.

Defined contribution plans do not fit as well with the apparent purpose of the special tax incentive. On the other hand, it must be recognized that defined benefit plans do not adequately provide for those who change employers even if they do so after benefits are vested. This is a complex

question beyond the scope of this hearing but I believe we need to make the regulatory burden on defined contribution and defined benefit plans more equal and to strengthen the latter as to short service employees. Certainly, I would be concerned about approaches which facilitate the use of defined contribution plans such as § 401(k).

Section 401(k) - CODAs

Ordinarily, if an employee has a choice to receive cash he may be taxed even if the money is, at his direction, used for another purpose such as deferred compensation. The employee is said to have "constructively recieved" the compensation. Under § 401(k), however, an employee is not taxed on contributions on his behalf to a profit-sharing plan even though he could have demanded payment to himself instead. If the condition of the section are met, constructive receipt does not apply. These plans are troublesome for two related reasons.

First, since employees are given a choice, coverage may be lower than if the employer made the determination. Second, given the relative value of the tax incentives and ability to save, participation is very likely to be tilted in favor of the higher paid. How then can § 401(k) be justified?

Justification for § 401(k) [1]

The simple explanation for passage of Section 401(k) is the 1956 IRS ruling (Rev. Rul. 56-497, 1956-2 C.B. 284) that sanctioned this form of plan. Congress halted the practice in 1974 but grandfathered old plans. Since it is hard to get rid of something and disparate treatment depending on time of adoption is troublesome, there seemed only one choice.

A more theoretical reason may be given. Difference in tax treatment dependent upon whether the employer or employee controlled the form of payment puts enormous pressure on determining who made the choice in the face of efforts to disguise it and uncertainty as to the legal standards for constructive receipt. This is particularly so when the reason for the distinction - if the employer chooses, there will be a more equitable distribution of the benefits between low and high paid - isn't always well understood. Would it not be better to eliminate the intermediary, remove the issue of constructive receipt and determine directly whether non-discrimination is satisfied? Hence § 401(k).

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[1] See Halperin, Cash or Deferred Profit Sharing Plans, 41 NYU Institute on Federal Taxation, Chapter 39.

Some would also argue that section 401(k) increases coverage. Since the contribution comes explicitly and directly out of wages, employer's may be more willing to establish plans than if they had to count on being able to reduce pay or restrain wage increases to recoup their costs. Thus, § 401(k) would lead to retirement savings that would not otherwise exist. The other side of the coin is that § 401(k) may replace more traditional retirement plans that had more widespread coverage or provided defined benefits to employees. The Committee should gather whatever information it can on this issue.

The picture as to coverage must be weighed along with the reasons that led to the adoption o § 401(k) in the first place - the previous existence of "§ 401(k) type" plans and the difficulty of applying constructive receipt rules - to determine whether the approach is appropriate. But even if the tenative conclusion is favorable, the issue of discrimination must be considered.

Section 401(k) and Discrimination

Acceptance of § 401(k) depends upon the actual provision of retirement benefits on a non-discriminatory basis. Has the 1978 legislation lived up to that promise? If not can it be improved upon or should the experiment be discarded?

Under present practice the qualification of a plan for special tax benefits is determined by comparing the ratios of participants to total employees for two groups - owners, shareholders and highly paid (the so-called prohibited group) and all others (the non-prohibited group). According to the regulations a reasonable difference in the two ratios is acceptable but there is neither a precise meaning of what is "a reasonable difference" nor a clear line as to who is in the prohibited group.

The Administration (Chapter 14.09) would specifically define the prohibited group and, subject to special circumstances, would generally define a reasonable difference as 25% greater (for example, if only 50% of the non-prohibited group is participating, participation by the prohibited group must be limited to 62½% (125% of 50%)). In contrast under present practice a difference of 300% or even more might be allowed. I support the Administration's proposals subject to hearing testimony as to particular problems.

In a non-elective plan contributions for each participating employee are generally an equal percentage of pay. A difference in the portion that vests is tolerated however. It is also permissible to take contributions to

the Social Security program into account in determining equality.

Section 401(k) requires passage of the reasonable difference test as to eligibility but does not require an equal level of contributions for each eligible person. A plan qualifies as long as the average ratio of contributions to compensation for the highest paid one-third of those eligible is no more than 150%[2] (or in some cases 250%) of the average for the lowest paid two-thirds. Probably the highest paid one-third will include people not in the prohibited group, but it is also possible for prohibited group members to be in the lower two-thirds. Section 401(k) plans may not take account of contributions to Social Security and in contrast to non-elective plans, all contributions must be non-forfeitable.

There are a number of difficulties with the § 401(k) test for discrimination which are brought out by the Administration's proposals.

1. Comparison between the top one-third and the rest can produce peculiar results. It would be better, as the Administration recommends, to compare the prohibited group to other employees.

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[2] The 1956 Revenue Ruling permitted a 200% disparity.

2. Section 401(k) can permit double discrimination - a "reasonable diffrence" in eligibility followed by an additional disparity in the level of contributions. If the permitted difference in the level of participation in non-elective plans is viewed as a justification for § 401(k), the mechanical tests of § 401(k) should be applied to the workforce as a whole rather than a so-called non-discriminatory group of employees.

3. Section 401(k) compares average benefits rather than individual benefits.

For example, assume a company employs 6 people - A, B, C, & D each of whom earn $10,000 and E & F who earn $100,000. Under § 401(k), if A, B, C, & D each contribute $600 or an average contribution of 6%, E & F could contribute $9,000 each or an average contribution of 9%. However, if F does not participate, E would be able to contribute 18% or $18,000 since the average among the high paid would still be 9%. Under the Administration's proposal, the amount that E could contribute would be based solely on the average contribution of A, B, C, & D. Whether F contributed, or not would be irrelevant. (The limit would be the greater of (a) 125% of the average contribution (7½% = 125% of 6%) or (b) the lesser of 200% or 2 percentage points (here 6% + 2% = 8%)

a. Allowing E to contribute 18% would clearly be inappropriate if the average contribution of the top one-third was reduced by non-participation by relatively low paid people who happened to be in the group. The Administration proposal to make the comparison between prohibited group members and others deals with this problem.

b. Section 401(k) now allows a 250% disparity in contributions between low and high paid individuals, if the aboslute difference is no more than 3%. (The Administration would reduce this to 200% and 2%.) It was presumably thought that plans with a relatively low contribution level were not a serious abuse problem. However, this is not the case where an average contribution level of say 5% disguises absolute contributions of as much as 18% or more. If the average comparison is to be retained, it should not be applied to the alternative mechanical test designed for low contribution levels.

c. If these two adjustments are made, we are left with the question of whether (assuming identical contributions for A, B, C, & D in the two situations) we are concerned about how E & F divide the tax benefits of the $18,000 contribution. Would we be more concerned if F earned only $50,000 and E earned $150,000? While I view the answer as uncertain as a matter of "theory" probably on

appearance alone, the Administration's approach would be best. This is particularly so if their general objective test for non-discrimination were approved so that in a non-elective plan it would be more unusual for E to receive a contribution double the average of A, B, C, & D. (This could occur under present law if, for example, a plan which included A, B, E, & F would be considered non-discriminatory; it could still occur under the Administration's proposal if the plan included only A, B, & E - A 10% contribution level would average 5% for A, B, C, & D.)

To summarize, Section 401(k) plans may be more discriminatory than non-elective plans because of the permitted disparity in contributions among a group that need only just meet the non-discriminatory classification standard. Further, the average difference in contribution level between the top one-third and others may disguise a very large difference between the contribution for a prohibited group member (or even all prohibited group members) and the average contribution for non-prohibited group employees.

By dividing employees between the prohibited group and the non-prohibited group, the Administration would limit the difference in average contributions for prohibited group members and others to the statutory permitted difference.

This is clearly appropriate. By testing on an individual basis the Administration would also limit the difference between the contribution for any prohibited group member and the average for non-members to the statutory standard: I believe this is clearly appropriate as to the 200% test but may reasonably be subject to a difference in view as to the 125% allowance.

The Administration also would reduce the permitted disparity under the general rule from 150% to 125%. The appropriate level may depend upon what degree of difference in vesting would be tolerated in non-elective plans. There is no clear answer to that question nor is one suggested by the Administration (The decision may also be influenced at some point by possible future changes in the rules for integration with Social Security).

Maximum Contribution ($8,000)

In contrast to the $30,000 which may be contributed annually to profit-sharing plans, the President would impose an $8,000 maximum on § 401(k) contributions, reduced by any contribution to an IRA. The Administration's proposals may well require § 401(k) plans to be no more discriminatory than ordinary profit-sharing plans. If so, then the reduced limit must be intended to maintain an incentive for non-elective plans. As suggested above, this is appropriate

if it is believed that § 401(k) plans tend to replace non-elective plans that would have more widespread coverage.

In any event there is no reason to link the $8,000 maximum to the existence of an IRA. People who can afford $8,000 per year are generally sophisticated enough to start their own IRA or the employer can offer a payroll reduction IRA. The limit should be $6,000.

Contributory Plans:

Under a contributory plan, an employee who agrees to participate by making his own contribution (on an after-tax basis or under a CODA) shares in an additional employer contribution, which would not be available to him in the absence of participation in the plan. Contributory plans, thus, differ from § 401(k) plans in that a non-participating employee earns less overall. I have always found this more objectionable than § 401(k). In part, perhaps because these plans did not raise constructive receipt questions, (thus obviating one argument applicable to § 401(k)) and seem to hold out the likelihood of a greater disparity in contributions than permitted under § 4C1(k). An outright prohibition on contributory plans is appealing.

The Administration appropriately recommends applying the § 401(k) standards to contributory plans which provide

non-forfeitable benefits and prohibit distributions prior to separation from service.

A smaller, 110%, leeway is applied to plans which cannot meet this standard. It would be more sensible to eliminate the separate test and apply the general 125% allowance to actual participation in contributory plans rather than eligibility to do so.

Distributions - Pre-Retirement

Pension plans are prohibited from paying benefits prior to separation from service or termination of the plan. This applies not only to defined benefit plans but also defined contribution pension plans known as money-purchase plans. Section 401(k) plans (CODAs) are subject to these rules unless the employee has reached age 59½ or has suffered a financial hardship. (The Administration apparently proposes to eliminate both these exceptions thus fully extending pension plan treatment to § 401(k).) Special plans for employees of tax-exempt institutions (§ 403(b) plans known as Tax Sheltered Annuities (TSAs)) are subject to the current § 401(k) restrictions if invested in mutual fund shares but not if the investment is in annuity contracts. (The Administration would extend these rules to annuity contracts and eliminate the hardship exception.)

Profit sharing plans on the other hand can make

distributions at any time although unless another "event" has occurred contributions must be held for two years. (No change is proposed in these rules.)

Distributions to 5% owners from a profit-sharing plan or form a pension plan on early separation from service or termination of the plan are subject to a special 10% excise tax unless the employee has reached age 59½. A similar rule applies to distrubtions from an Individual Retirement Account (IRA) before age 59½ (The Administration would apply the penalty to distrubtions to anyone prior to age 59½ and increase it to 20% unless used for college tuition, the purchase of a first residence or to replace expired unemployment benefits.)

The penalty tax would seem generally intended, through recapturing part of the tax benefit, to discourage intentional use of an IRA or a controlled corporate plan for short-term savings. As extended to distributions to rank and file employees, it would have the related purpose of preserving benefits for retirement, carrying out the goal of the non-discrimination test.

The Administration also appropriately recommends the elimination of the special averaging rules for lump sum distributions. Since tax can be deferred by a rollover to an IRA, the special averaging is an unwarranted benefit

which only encourages early spending. It is also sensible to prohibit early tax-free withdrawals of amounts equal to employee contributions[3]

As stated above the justification for the special tax treatment for qualified retirement plans is the unusual difficulty of saving for retirement. Many would oppose extending the prohibition against pre-retirement distributions to profit-sharing plans; they argue that profit-sharing plans have goals other than providing for retirement. This argument may be correct but it proves too much. If retirement is not the focus, the special tax treatment is not justified in the first place. In

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[3] The other side of the coin is to defer distribution despite retirement to continue the benefit of the tax-free build up for one's heirs. Under penalty of plan disqualification distribution must begin soon after retirement (or if earlier age 70½ for a 5% owner) and proceed under "a minimum distribution" schedule roughly designed to approximate the life (or life expectancy) of the employee and a beneficiary. In the case of an IRA a delayed distribution is penalized by a heavy excise tax. The Administration wisely would substitute an excise tax for the penalty of disqualification and promises simplifying modifications to ease calculations. It also proposes changes in basis recovery rules for contributory plans which would in effect take account of mortality gains and losses for tax purposes. I recognize the potential simplification and more importantly the reduction of the benefit from erroneous estimates (?) of life expectancy. All else being equal, however, I think it would be best to ignore mortality gains and losses. For one thing an increased tax burden beginning when one lives beyond life expectancy is troublesome.

particular, if it is correct that a potential interest in profits increases productivity, employers do not, and should not, require a government subsidy to act in their own self interest. Thus, the prohibition against distributions prior to separation from service is appropriate and ideally should be extended to all profit-sharing plans not just § 401(k) plans.

Under this regime the penalty[4] on pre-age 59½ distributions from employer plans would apply only in the case of plan termination or early separation from service and would tend to encourage rollover of distributions into an IRA in those circumstances.

However, particularly where there is an explicit choice of whether to participate, employees may be reluctant to do so if funds cannot be reached until retirement. Some would argue, therefore, that a prohibition on early distribution actually reduces retirement savings (the Committee should not accept this assertion without evidence). Moreover, it may be difficult to tell people with real needs that they cannot get the funds at any price especially if they view it as their own money as under an IRA and perhaps § 401(k). On the other hand, it is hard to police a hardship standard.

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[4] It would also apply to early distributions from an IRA. It might be difficult to prohibit distributions from an IRA since IRAs can always be terminated.

This requires a difficult balancing. Perhaps distributions could be allowed to meet specific medical bills. Purchase of a residence and college tuition are totally expected events and use of a qualified plan to save for them is inappropriate.

Certainly an individual who uses funds for other than retirement purposes (whether from an IRA, from a pension plan on plan termination or separation from service or a profit-sharing plan if pre-retirement distributions remain permitted) should be no better off than if he had not participated in the plan in the first place (an exception may be reasonble for medical emergencies or unemployment but again not college tuition or purchase of a residence). The Administration proposed excise tax is defective. There is no justification for a reduced burden for those who pay tuition or buy a home. More importantly the tax as proposed is a uniform percentage of the distribution. Since the benefit varies with the rate of return under the plan, the length of participation and the marginal rate of the individual, it is not possible to exactly recapture the tax savings, but you can get closer than the Administration proposes. It should be relatively easy to relate the penalty to the tax bracket at the time of withdrawal. Failure to do so will recapture more of the tax savings from

those in lower brackets. While this may help foster retirement savings for these people, it fails, in particular, to prevent use of IRAs for short-term savings by high paid individuals. In addition I believe it may be possible to relate the penalty more closely to the rate of return and the period of participation by basing the penalty on the excess of the distribution over the orginal contribution rather than the total distribution.

Loans

In certain circumstances, loans from qualified plans are permitted where distributions would be prohibited. Moreover, loans that do not exceed specified statutory limits are not considered income to employees as distributions would be.

The only reason to favor loans over distrubtion would be the possibility that loans will be repaid and be availabe for retirement. Otherwise a loan is more troublesome, the tax on the income must be paid in the future but there is no distribution from which to pay it, further weakening retirement security. Secondly, the tax benefits of the qualified plan continue even though no funds are being accumulated for retirement.

Under current law, loans are taxable unless required to be repaid within 5 years (or a reasonable time if in

connection with a purchase or improvement of a principal residence). The Administration proposes to make the 5 year limit a reality by prohibiting reborrowing for a 12 month period and by limiting the exception for residence loans to the first purchase.

The Administration recommendations are clearly appropriate. Moreover, if loans cannot be totally prohibited, a deduction for interest on loans to qualified plans should be denied (See the related proposal as to IRA contributions said to be under consideration - Chapter 14.01 at 341).

Conclusion

The tax subsidy for qualified plans is intended to encourage employers to supplement Social Security and provide income replacement at retirement for low and moderate income workers. Ordinarily the tax incentive will not work unless the decision to establish the plan is made at the employer level. The difficult issue relating to § 401(k) is whether the tax benefits should be provided for what amounts to individual savings if such saving is in fact part of an overall non-discriminatory program.

Section 401(k) can be acceptable if it does not result in a reduction of savings and if it produces non-discriminatory retirement benefits.

Early distributions and loans from qualified retirement plans should be curtailed. If allowed they should be subject to a penalty which recaptures the tax benefits.

STATEMENT OF JOHN P. THOMPSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE SOUTHLAND CORP., DALLAS, TX

Mr. THOMPSON. Thank you, Mr. Chairman, and members of the committee. I appreciate being here today, and I am really doing it on behalf of 34,000 of our company employees who are participants in our savings and profit-sharing trust fund. We have had a profit-sharing plan for 35½ years. It started in 1949, and it exists today with the same basic concepts on which it started. I am here today to advocate public policies that will encourage and promote employee participation in plans such as ours so that they can have financial security when they retire. The particular question we are to address here this morning relates to the tax benefits for early distributions for financial hardship and some other reasons. We have had those. The question is: Should they be taken away? My answer, for some very practical reasons, is no; they should not be taken away. We feel that public policy and tax policy also should be directed toward promoting savings for retirement. Let me tell you a little about our plan. First of all, 84 percent of eligible employees are members of our profit-sharing plan, and 80 percent of those make less than $25,000 a year. The employee, contributes 6 percent of their compensation up to a limit, and the company puts in 10 percent of its pretax earnings. Allocations are made from the company contributions based on length of service, so that as one approaches retirement age, they get more of the company contribution. We feel that this is a very fine thing to promote the savings for retirement. When the 401(k) plan really came in 1981, participation in our plan increased 33 percent.

The CHAIRMAN. Let me get that. You have got 84 percent participation now?

Mr. THOMPSON. Yes; it was 63 percent.

The CHAIRMAN. All right.

Mr. THOMPSON. Now, most of our participants have no other savings, and we feel that unless they have access to the savings in our plan, that they would very likely not choose to participate. I would particularly like to tell you about our Canadian operation. In Canada, the laws provide—well, they are very, very restrictive on any withdrawals. They are very difficult and very restrictive, and in Canada, participation is only 50 percent of eligible employees. Now, we feel that, if too many restrictions, too many penalties are put on the withdrawal opportunity, that this would knock down our percentage of participants to close to the same thing that we are actually experiencing in Canada. We feel that the proposed penalty taxes on withdrawals are really higher than they should be. An employee would have to leave his money in our profit-sharing plan for 19 years before the proposed excise tax—the 20-percent excise tax—would actually be recaptured, or would recapture the tax benefits that they receive. We think the excise tax is a very severe penalty placed on someone who needs money for financial hardships and then, when they need the money the most, you penalize them for taking it out.

I would like to give you some figures on those that have withdrawn. I asked our plan administrator to take a look and see what has actually happened to our retirees. Fewer than 30 percent of

our long-service employees made a withdrawal prior to their retirement. And the withdrawals amounted to only 3.4 percent of the total balances when they retired. Those account balances average seven times their last year's compensation, and the income from those balances yield over 100 percent of that employee's last year's compensation. So, I would say to you that our plan works, in spite of the fact that we allow withdrawals for certain financial hardships, and we feel that they should be maintained without such penalty. As I said earlier, our plan has worked, is working. We think it does an excellent job of taking care of our people when they retire. We urge you to remove chapter 14 from the tax reform package and continue supporting policies that promote private savings and retirement plans. Thank you.

[The prepared written statement of Mr. Thompson follows:]

TESTIMONY OF JOHN P. THOMPSON
Chairman and CEO, The Southland Corporation

before Senate Finance Committee
Thursday, July 11, 1985

on Tax Policies Related to
Alternative Retirement Arrangements

Mr. Chairman and Members of the Committee, my name is John Thompson. I am the Chairman and Chief Executive Officer of The Southland Corporation, a company perhaps best known as the originator of the convenience store concept and operator and franchisor of 7-Eleven stores. Southland also is a major processor of dairy products marketed under eleven well-known regional names such as Embassy here in the Washington area. CITGO Petroleum, Chief Auto Parts, Reddy Ice, Southland Distribution, Fast Foods are all a part of the Southland family.

I am particularly pleased to address you today on behalf of our company and especially on behalf of our 34,000 employees who participate in the Southland Employees' Savings and Profit Sharing Plan. Many years ago, my father, Joe C. Thompson, who founded Southland, testified before Congress on the virtues of profit sharing. He established our plan in 1949 and it has remained intact under the same basic concepts adopted then. Like my father before me, I am here today to advocate public policies that will encourage and promote employees to participate in plans such as ours so that they can provide for their own financial security in retirement years.

The particular question being raised is whether tax benefits relating to early distributions for financial hardship and other specific uses, which have long been accepted as part of such plans, should be taken away. For very practical reasons, the direct answer to that question is no. Public policy, including tax policy, should be directed to promoting savings for retirement.

Southland employees are typical of the 19 million American workers eligible to participate in 401(k) plans. Eighty percent of our participants earn less than $25,000 per year. Despite the discipline required to set aside a portion of each paycheck for savings, 84 percent of our eligible employees participate in our plan where they contribute 6 percent of their compensation and the Company contributes 10 percent of its pre-tax income. Company contributions are allocated on the basis of years-of-service so that the benefits of the plan, as in a defined benefit pension plan, accrue more rapidly as the employee approaches retirement. With the advent of 401(k) in 1981, participation rate in our plan increased 33 percent.

Most employee participants have no other savings and unless they know they can have access to their savings in times of real need, they will very likely choose not to participate. The experience of our Canadian division supports this contention; under Canadian law, withdrawals of contributions to plans such as ours are heavily restricted. The negative impact of this policy, well-meaning as it might be, is that only 50 percent of our eligible Canadian employees have enrolled in profit sharing. We would anticipate an equally low participation rate in this country under such a law - a participation rate below the 70 percent required for plan qualification.

We are concerned that the penalty taxes proposed in the President's tax reform package will have just such a chilling effect on savings participation. They are far more than recapture taxes as they have been represented to be. The 20 percent and 10 percent excise taxes on early distributions go well beyond recapturing the benefits associated with deferring taxes on contributions and interest on those contributions, especially for the typical Southland participant who makes under $25,000 per year. Our employee would have had to leave his or her contribution in the plan for 19 years before the proposed excise tax actually re-captured the tax benefits from deferral.

The proposed excise tax is a severe penalty to levy on a person, especially considering that it will be levied when the employee is experiencing financial hardship. Instead of discouraging pre-retirement distributions, we fear that the penalty taxes actually will discourage participation.

Providing accessibility to contributions, however, does not mean that employees will use their savings before retirement. We are still a young company with relatively few retirees. Prior to coming here, I asked our profit sharing administrator to examine the accounts of our long-service retirees to see first if any had made withdrawals prior to retirement and second, if so, did such early distributions endanger their ultimate retirement accounts. The results may surprise you. Fewer than 30 percent percent of our long-service employees ever made a withdrawal prior to retirement and, of those who did, the withdrawals amounted to less than 3.4 percent of their final account balances. Those account balances amount to an average of seven times the retirees' final salaries and are yielding over 100 percent of their final salaries in earnings alone. This is independent of any social security benefits for which they may qualify. Our plan works. It works even though early distributions for hardships are permitted, and perhaps because they are permitted.

There are a number of other proposed changes in the President's tax reform plan that would critically impact on our plan and would cause radical changes to be made to profit sharing and other alternative retirement arrangements. Others today and later this month will be addressing how these specific changes will negatively impact our plans and, in some cases, will cause plans to be terminated.

In summary, retirement plans like Southland's, which permit employees to make withdrawals for hardship reasons, work. Employees save for their retirement, and they have the peace-of-mind that they will be financially able to deal with hardship emergencies should they arise.

Our employees are typical of hard-working, middle Americans. They are the very ones that benefit the least under the President's tax reform proposal; yet, they have the most to lose under policies which discourage alternative retirement and savings accounts.

We urge the Committee to remove Chapter 14 from the tax reform package and to continue supporting policies which promote private savings and retirement plans. Thank you.

The CHAIRMAN. Mr. Thompson, on page 4 of your statement, you said fewer than 30 percent of our long-service employees have ever made a withdrawal prior to retirement; and of those who did, the withdrawals amounted to less than 3.4 percent of their balance. What is your definition of long-term?

Mr. THOMPSON. I am using 20 years as the definition of a long-service employee.

The CHAIRMAN. All right. What is your experience with short-term employees?

Mr. THOMPSON. I don't have that figure. We don't have that figure. There are some that, you know, withdraw their entire——

The CHAIRMAN. Despite the fact that less than 30 percent of your long-term employees withdraw, and there they withdraw a relatively slight amount apparently, in comparison to their balance, you are still convinced that the privilege of withdrawal is an inducement, even though most of them never use it?

Mr. THOMPSON. Yes, sir; I do, because most of these folks don't make a lot of money, and they don't have other savings, as Senator Long pointed out a while ago. And the fact that they know their savings are there in case they have got an illness in the family, in case they want to buy a home, which we think is a good thing for their retirement, for real financial hardship, we believe that the knowledge and the comfort of knowing that you can get to those savings encourages participation very highly. And I would point out that Canadian experience as the other side of the coin.

The CHAIRMAN. Now, Dr. Halperin, what is wrong with his answer, because you would really severely limit the right of withdrawal except under very unusual circumstances?

Mr. HALPERIN. Senator, I am not sure there is anything wrong with that answer. I think we have a dilemma here, as we usually have, when we try to encourage voluntary behavior to get to a certain goal. If we push too hard for the goal, we may get less in terms of the behavior we want. So, I recognize the potential legitimacy of the position that we conceivably would get more retirement savings if, in fact, we let people have the option of withdrawing under certain circumstances because most people in fact will not withdraw. So, I think that that is an issue that you have to examine and try to get the best information you can as to whether that is true in all circumstances and whether limitations can be put on it without affecting that.

The difficulty, I think, with the present rule in 401(k), which says you can have a distribution in the event of hardship, is that it is very hard to enforce. If employers want to use the hardship exception as a way of running the low-income people in and out of the plan and not provide retirement savings, it is very difficult to stop that from happening. So, at least, if you are going to have withdrawals from 401(k) plans, and I would tend to believe that you probably have to—that you can't get away with the proposal that the administration makes—that would outlaw them completely—that it would make sense to have some sort of a restriction on it that would tell people that if you are going in, you are not going to be getting the benefits of the qualified plan, and perhaps you might have even a little bit of a detriment if you withdraw it early so

that they recognize that they are committing themselves to retirement.

It is important, though, I think, to have the penalty correct. You are basically saying to the high incomes people under today's law (and a lot of people think about this when they establish IRA's) as long as you leave it there for 4 or 5 years you are ahead. What have you got to lose? While you are saying to a low-income person: You may have to leave it there 9 or 10 or 11 years. And I think this is backwards. I think the incentives really ought to be the other way around. It is the lower income person who has the most trouble, and is most likely to be saying to himself: I would like to save for retirement, but I might need this money. And he is going to focus on the potential penalty. If you can say to him: If you take it out, at least you won't be significantly worse off than if you never put it in in the first place, that is a big difference than having a penalty which is harmful. So, they shouldn't get an advantage through the plan if they are not saving for retirement. The problem with "no penalty" is they can use the savings and come out ahead, even if they had no intention to use it for retirement. But it may not be essential to make them worse off at least as to certain reasons for withdrawal, In any event, I think we can do a better job in rationalizing the penalties

The CHAIRMAN. Mr. Thompson, give me those figures again. You went from 61 percent to roughly 83 percent participation when you went——

Mr. THOMPSON. Sixty-three to eighty-four, I believe, Senator.

The CHAIRMAN. When you went to the what?

Mr. THOMPSON. Well, when in 1981 when the 401(k)——

The CHAIRMAN. Now, do you see a shift more and more away from traditional retirement plans and to 401(k)'s? That is assuming no change in the present law?

Mr. THOMPSON. I am not really an expert on that, Senator. I would think that it would tend that way certainly, but I don't know.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I just want to explore again the point the chairman was making in his question to you, Mr. Thompson. Your statistics show that your retirees in the course of their careers took very little out of the plans?

Mr. THOMPSON. That is correct, sir.

Senator CHAFEE. And therefore, you conclude that there is not, if you want to use the expression, a "great abuse" of it in the terms of early withdrawal. The logical question is then: if they don't take much out, then what is the harm in having the penalty? Your answer to that was that would discourage them from going into the thing in the first place because this is put down as a pool of capital and it is available in case somebody in the family gets sick. Now, your Canadian experience. You cite that up in Canada only 50 percent of your eligible employees are in it. Frankly, that isn't a great deal different that what you had in the United States prior to the 401(k). Is that correct?

Mr. THOMPSON. The percentage is 13 or 14 percent.

Senator CHAFEE. Yes.

Mr. THOMPSON. But for different reasons, I think.

Senator CHAFEE. Maybe Canada doesn't have something as attractive as a 401(k). Is that true? I don't know Canadian law.

Mr. THOMPSON. I don't know. I am told that it is the same in that respect.

Senator CHAFEE. It is the same? I must say I was a little confused by page 4 of your testimony, where you talked about the amount balances, the amount they had in these savings accounts, came to seven times their final salaries.

Mr. THOMPSON. That is correct, sir.

Senator CHAFEE. And then you said: "And that is yielding over 100 percent of their final salaries."

Mr. THOMPSON. That is correct.

Senator CHAFEE. The way I work it out, you are getting a 14 percent return. Whoever is handling this is doing it extremely well.

Mr. THOMPSON. Thank you. [Laughter.]

And thanks to them.

Senator CHAFEE. You are getting a 14 percent return?

Mr. THOMPSON. Sixteen.

Senator CHAFEE. Sixteen? Well, you ought to be Treasurer of the United States. [Laughter.]

What do you have it in that you are getting 16 percent?

Mr. THOMPSON. Basically, if you are interested, I will tell you. We have some in our company stock and some in real estate that is leased to our company, some in some other real estate ventures that are run by outside people.

Senator CHAFEE. I see. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. Dr. Halperin, you said you wanted to answer a question that I asked earlier. Which one did you want to answer?

Mr. HALPERIN. I was going to answer your question about where money comes from to go into IRA's. I can tell you where it comes from in my case. It comes from borrowing.

Senator BRADLEY. All right.

Mr. HALPERIN. And since you get the interest deduction on that borrowing, in effect you get the tax benefits without having any retirement savings at all. And in some ways you are worse off because you are going to have to pay the tax in the future. So, for those people, they are in the hole. And we have a totally backwards incentive.

Senator BRADLEY. All right. That is very interesting, and I would like you to take it slower for C-Span. [Laughter.]

Now, you are saying that the purpose of an IRA is to increase retirement savings. Right?

Mr. HALPERIN. Right.

Senator BRADLEY. That is the purpose, and also to increase savings. But nationally, savings has not increased, which means people are simply taking money out of one savings vehicle and putting it in another. Naturally, you would like to take your money out of the savings vehicle that is taxed at 50 percent or 20 percent and put it into a savings vehicle that has no tax. That is commonsense. But you are saying something more. Could you go through it very slowly?

Mr. HALPERIN. Some people are not even moving savings. They are borrowing the $2,000 and they owe a bank $2,000, and then they take that money and put it in another account that could presumably be in the same bank.

Senator BRADLEY. So, they borrow $2,000 from a bank and they put it in this tax-free IRA? Right?

Mr. HALPERIN. Right.

Senator BRADLEY. They have to pay interest on that loan though, right?

Mr. HALPERIN. They pay interest on that loan which is tax deductible. So, if you are paying, say, 15-percent interest on that loan and you are in a 50-percent bracket, it only costs you 7.5 percent. So, if you can make 10 or 12 percent in an IRA, you are ahead, even though you are paying more interest than you are earning. And when it comes to retirement, you take the $2,000 out of the IRA and you have to do two things with it. You have got to pay off the $2,000 loan and you have to pay $1,000 to the Government. There isn't enough there to do both, so you not only have not saved for retirement, you have dissavings And we have a totally backwards incentive.

Senator BRADLEY. You mean to say that what the Congress intended didn't really happen?

Mr. HALPERIN. It doesn't really work in that case, and I noticed the administration is suggesting in its proposals that we ought to think about denying interest deductions for investments in IRA's. I think we ought to do more than think about it. We ought to do it. And we ought to certainly disallow deductions for people who borrow money from their plans, which is even easier to do.

Senator BRADLEY. Mr. Thompson, what is your perception of what the purpose of the 401(k) plan is? What is the purpose? Why did we establish the 401(k) plan? Was it to increase retirement savings?

Mr. THOMPSON. I would suppose so, sir. I am not familiar with that, but I would think that is a very good reason.

Senator BRADLEY. And yet, as you described the way your company uses it, it is the equivalent of a tax-free savings account for your employees? I mean, they can put it away tax free, and they can pull it out any time they want to, certain hardships being met.

Mr. THOMPSON. It is not any time want to. It is for financial hardship reasons.

Senator BRADLEY. Yes; it is an interesting problem. I mean, I think it goes to what you said, Dr. Halperin, which is you have to define what the purpose is, and then you have to weigh the competing claims. I mean, there is no doubt in my mind that there are plenty of peple out there who have unexpected emergencies and need money. The question is: Is it the purpose and did we intend the 401(k) plan to be a rainy-day fund, or to be a retirement savings plan?

Mr. THOMPSON. I say it could be both, but we encourage saving for retirement and we discourage withdrawals unless it is really financial hardship.

Senator BRADLEY. All right. Thank you both.

The CHAIRMAN. Senator Long.

Senator LONG. This has been an interesting subject, and I would just like to go a little further. Under this self-employed IRA concept, the person can contribute as much as $30,000. Doesn't the IRA for self-employed people go beyond the $2,000 limit?

Mr. HALPERIN. Well, if the person has his own company and he is self-employed and has nobody working for him, then in effect he establishes a regular plan just like everybody else; and he could put $30,000 a year in it if he wants to.

Senator LONG. So they could $30,000 worth in it?

Mr. HALPERIN. Senator Long, it is in effect the same as a regular retirement plan, except that you have no employees. So, it is really an IRA as far as you are concerned, and the limit is $30,000.

Senator LONG. This person is going to have an account that is just too good to miss. At the end of the year, he is eligible to participate in this self employment plan and contribute up to $30,000. That is just too good a deal to miss, so he goes out and borrows the $30,000. Now, that is not a savings. He borrows it, and he is $30,000 in debt. All right. he takes that and he puts that in the IRA. Now, in a 50-percent tax bracket, that fellow has made $15,000. Would you mind explaining now what is the future consequence? I mean, now he has cut his taxes. He has saved $30,000, and he has saved $15,000 on taxes by borrowing $30,000. But now, what will the future consequence be when he retires?

Mr. HALPERIN. His consequences, when he retires, is that he owes money on the loan that he borrowed the $30,000. He also owes money on the taxes when he withdraws the money from his pension plan. And there isn't enough money in the pension plan to do both, assuming that he has borrowed the entire amount that he has put in. He is going to have to use the withdrawed amount to pay off the loan. The taxes are going to have to come from some place else, Senator. So, he is worse off than if he hadn't gotten involved in the first place as far as his retirement security is concerned.

Senator LONG. He may be losing something, but it looks to me as though he got $15,000 ahead. He has $15,000 drawing interest for him.

Mr. HALPERIN. He is living pretty well, and he is well ahead, and his spending has increased. He is able to increase his current consumption. He is no doubt better off in total, but if you want to look at his retirement security, he could well be worse off. But, yes, he has saved taxes currently and he has made money on us.

Senator LONG. Isn't this correct? He only pays when he draws it out?

Mr. HALPERIN. Yes. Senator.

Senator LONG. So, he is in a position to draw it out at the point where it is not going to adversely affect him too much?

Mr. HALPERIN. Yes, and I would guess that people in high income brackets don't have much of a change in their post-retirement tax bracket. But to the extent it goes down, he gets that advantage, too.

Senator LONG. Now, Mr. Thompson, I want to ask you something about your testimony. Does it help to solve the problem you have in mind about people who need some money if the company simply had a credit union? Rather than take money out of the savings

plan, perhaps it might be desirable for them to borrow money from a credit union if the company had a credit union. In that case, I would like to know if it would be desirable for the credit union to be in a position to look upon the person's money in this profit-sharing plan as collateral to guarantee such a loan?

Mr. THOMPSON. Senator, we do have a credit union, and our employees use it and do borrow from it, but our profit-sharing fund is, I guess, the last resort if they have to go into that. They don't like to do it because it makes good money for them. And as I pointed out, the figures discourage it.

Senator LONG. Offhand, it would seem to me that it would be best to leave the money that is earning them good income where it is, and it seems to me that it ought to be to their advantage to leave it there and borrow the money from the credit union. And in borrowing the money, you could put on the application that you have this money over here in this profit-sharing plan. Then, couldn't it be worked out that if worse came to worst, the credit union could collect from the profit-sharing plan, or could that be arranged?

Mr. THOMPSON. I suppose it could, but you would have to change the law. You can't do that now.

Mr. HALPERIN. We don't allow that under present law.

Senator LONG. Now, wait a minute. That is what we are here for, to change the laws. [Laughter.]

But would you recommend that, that we ought to consider changing the law so they could do that?

Mr. THOMPSON. Not necessarily. I would have to think about that pretty long and hard, but our employees do use the credit union the most they can because they don't want to withdraw from the profit-sharing plan because it does make them such a good return.

Senator LONG. Yes. Thank you very much.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman. You really have a couple of very capable witnesses to argue the two sides of it, two of them whom I have respected for a long time. Mr. Thompson, you made a point about your Canadian employees. Now, that is a rather telling point to me. Now, as I understand you, you have a very high percentage—85 or 90 percent or so?

Mr. THOMPSON. Eighty-four percent, sir.

Senator BENTSEN. On your U.S. employees, down to about 50 on your Canadian employees, and you think that is because of the tough withdrawal penalties. Is there any other ameliorating fact in that?

Mr. THOMPSON. Senator, not that I know of. I will ask some of the folks that may be more familiar with it than I if there are and then tell you. We don't know of any. In other words, the situation is mostly the same. We encourage our employees to join profitsharing in both places just as much. The rules otherwise are pretty much the same, so we cannot say that there is anything but that. There may be some other things that I don't know about.

Senator BENTSEN. I don't think it is either or in this situation. I think what we are trying to do is to encourage savings, and we are also trying to encourage savings for retirement, or savings for a rainy day, or an emergency. Now, it is a question of priorities, I

suppose, in this situation. I have been one who has felt very strongly that we ought to encourage in any way we can savings in this country. We have a great deficiency in that. We have a propensity for consumption. Where you have Japanese saving 18, 20, or 22 percent, and we have 6 percent in this country, and that is one of the many reasons we have a trade deficit with Japan. So, I was scanning some of your testimony and trying to—I think that point is a very telling point because that is an actual happening.

Mr. THOMPSON. That is true, and that is why I wanted to bring that out. To our knowledge, there is no basic reason other than that, that participation is so low.

Senator BENTSEN. Thank you very much.

Senator Long, do you have any more?

The CHAIRMAN. Gentlemen, I have no further questions.

Senator LONG. No, thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. THOMPSON. Thank you, sir.

The CHAIRMAN. Now, let's conclude with a panel of G. David Hurd from the Bankers Life in Des Moines; Walter Holan, the president of the Profit Sharing Council of America; and Edwin S. Cohen, a partner with Covington & Burling in Washington, DC, and a man whom we are well familiar with before this committee. Mr. Hurd, on behalf of Senator Grassley, he extends his apologies. He hopes to get back. He has gone to the Judiciary Committee to make a quorum, and they are in the process of doing some business that requires a quorum. We clearly don't have to have a quorum for hearings, but you do when you are marking up and sending things out. He sends his apologies and hopes to be back before the panel is done.

Mr. HURD. Thank you, sir.

The CHAIRMAN. Why don't you go right ahead first, Mr. Hurd.

STATEMENT OF G. DAVID HURD, EXECUTIVE VICE PRESIDENT, THE BANKERS LIFE CO., DES MOINES, IA: AND CHAIRMAN, ASSOCIATION OF PRIVATE PENSION & WELFARE PLANS

Mr. HURD. I am Dave Hurd from Des Moines, IA, executive vice president of the Bankers Life, and am appearing here as chair of the APPWP, the Association of Private Pension & Welfare Plans, which is an organization of employers who are plan sponsors and providers such as insurance companies and banks, and advisers to plans such as consultants, attorneys, and accountants. Our basic position is that the current system is a good one, that it is sound and it is fundamental to the financial security of rank-and-file workers and their families. Now, we see a partnership of the Government and the private sector between Social Security and employer-sponsored plans.

We feel that employer-sponsored plans are both an important portion of the total now and are growing in importance. A little over half of civilian employees participate in these programs, and about 70 percent of full-time workers over age 25 are involved. At the current time, about half of the couples that are retiring at age 65 have employer pension; somewhere in the range of one-third to 40 percent of single employees. By the turn of the century, over 80

percent of couples and two-thirds or more of single people will have an employer-sponsored pension when they retire. Internal Revenue Service figures show that a smaller fraction of the tax expenditures for pensions go to people making over $50,000 a year than does interest deduction on owner-occupied homes, than does property tax deduction on owner-occupied homes, and than does for the case of the local taxes. All this data is simply to illustrate that the present system is a broad-based system. It is a voluntary system, and we encourage it through the Tax Code and it accommodates all kinds of employers. We have a diverse and multicultural nation, and we need a lot of flexibility. The tax expenditure argument that sometimes is made against employer pensions is badly askew.

It assumes, first of all, unchanged behavior if pensions were taxed, and that clearly would not occur. It ignores that taxes are not foregone; they are deferred until the income is received; and that some three-fourths of the deferral goes to low- and middle-income workers. Our goal is to preserve and strengthen this system for rank-and-file workers, to prevent the need for expanded Government programs and the taxes to fund them. I would like to mention that there is significant capital formation. About one-fifth of new U.S. capital in 1983 came from retirement programs. These plans are long-range endeavors. We all know that. We don't think often enough that they require stability of policy and stability of law so that employers and employees can make long-range plans. An employer can't look at his shoe tops in planning retirement security for his employees. There is just too much change going on. Much of what is being talked about in the 1985 proposals is not fundamental to nurturing the system, but it does generate instability.

The maximum dollar limits on pensions tend to hurt benefit adequacy for rank-and-file workers. These dollar limits push a growing fraction of executive benefits outside the plan that covers rank-and-file workers, and as that occurs, a qualified plan has a tendency over time to provide smaller benefits for rank and file. It is a kind of an insidious impact that isn't immediately obvious. We are concerned about the instability of the law. We are concerned about driving executive benefits outside the plan for rank and file, and that that will accelerate unwinding of the security net we have built over the last 50 years. I thank the committee very much.

The CHAIRMAN. Thank you, sir. Mr. Holan.

[The prepared written statement of Mr. Hurd follows:]

TESTIMONY OF THE

ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

BEFORE

THE COMMITTEE ON FINANCE

U. S. SENATE

Mr. Chairman and Members of the Committee: I am David Hurd, Chairman of the Association of Private Pension and Welfare Plans (APPWP) and Executive Vice President of Bankers Life Company in Des Moines, Iowa.

The APPWP is a nonprofit organization, founded in 1967 with the primary goal of providing and fostering the growth of this country's private employee benefits system. The Association represents over 475 organizations across the United States: both large and small employers who sponsor plans and leading support organizations to private plans including banks, insurance companies, accounting firms, and actuarial and consulting firms. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

I.

Introduction

The APPWP welcomes this opportunity to present its views on those aspects of the President's tax reforms program which affect employer sponsored pension and welfare benefit programs. It should be emphasized at the outset that the APPWP does not appear before this Committee simply to represent special or narrow issues. A recent study of the Employee Benefit Research Institute reveals that, of the over 80 million

nonagricultural employees in the United States, over 47 million, or 59%, are covered by retirement plans, including more than 37% of employees earning less than $10,000, more than 57% of those earning between $10,000 and $15,000 and almost 72% of those earning between $15,000 and $20,000. The statistics on group health coverage are even more impressive. Of the over 15 million employees earning between $5,000 and $10,000, almost half were covered by group health arrangements on their current jobs. Of the almost 18 million employees earning between $10,000 and $15,000, more than two-thirds were covered. In higher wage brackets, coverage ranges from more than 80% to nearly full coverage. In short, our ultimate "constituency" includes a broad spectrum of America's working men and women.

The APPWP recognizes that tax rate reductions of the magnitude sought by the President must be accomplished in legislation which is approximately revenue neutral on an overall basis. We also recognize that the revenue neutrality limitation will compel this Committee to examine virtually all existing tax incentives, including those in which we are particularly interested. We would ordinarily welcome such an examination because we are convinced that this Committee continues to share our view that the basic economic and social policies that underlie the pension and welfare benefit provisions of existing law are vitally important to all workers and ought to be fostered through our tax system.

Quite candidly, however, the APPWP is deeply concerned that the search for revenues will, in the coming

months, become so intense that these social and economic policy values will not receive the attention they deserve. We are also deeply concerned that the combination of the hundreds of issues before you, coupled with the pressures to expedite the legislative process, may preclude careful pre-enactment analysis by this Committee of the implications of proposed employee benefits changes.

Nevertheless, we recognize that many of the existing tax incentives for employer sponsored pension and welfare benefit plans are, as a practical matter, likely to remain "on the table" for purposes of this tax reform bill. Therefore, our comments on those specific provisions of the President's tax reform program with which we are concerned are preceded by a more general discussion of three broad policy themes which we believe must guide your deliberations in the coming months if the unfortunate experiences of recent legislative efforts in the pension and welfare benefits area are to be avoided.[1/]

1/ In the 10 years since ERISA was enacted, we have seen five major pieces of tax legislation dealing with pension and welfare benefits. In the last several years, these changes in law have been considered and enacted with such rapidity that their often adverse impact has not been fully examined and they have placed employers and others in a position of being unable to cope with the law. For example, in 1982, Congress enacted special nondiscrimination rules for group term life insurance and a complex set of rules for so-called "top heavy" pension plans. In 1984, the 1982 rules were changed and even more complex rules relating to welfare benefit plans were enacted. Now, in 1985, the President has asked this Committee to repeal many of the changes made in 1982 and 1984 and to adopt new, and often equally complex, rules in their place. Nevertheless, this Committee's schedule can accommodate but one day of concentrated hearings on this important subject.

II.

Three Basic Principles Should Guide Future Legislative Action Concerning Pension and Welfare Benefit Plans.

A. Voluntary Action by Employers.

We have wisely not required private sector employers to establish and maintain prescribed pension and welfare benefit plans for their employees. Thus, the key to the success of our current broad-based private pension and welfare benefit system rests upon the voluntary decisions of employers to establish and maintain such programs. We have properly sought to encourage employers to do so through tax incentives which reduce the cost of those programs, subject to appropriate safeguards to assure that such tax-favored programs are available to a broad spectrum of employees. Through these incentives, Congress has stimulated the development of a private system which is sufficiently broad-based that American workers are increasingly less dependent upon Social Security and other government spending programs to meet the hazards of old age, death, sickness and disability.

In recent years, however, we have, perhaps unintentionally, begun to threaten this beneficial but voluntary system by legislation which cuts back on benefits, often in the name of deficit reduction, and occurs with such frequency that many employers are beginning to find the revised rules to be so restrictive and so complex that the incentives to establish and maintain employee benefits plans may be

insufficient. We need to be realistic. If we are going to continue to rely on voluntary decisions by private employers -- as we surely will -- we need to strengthen the incentives and not sacrifice much of what is left of them in the name of revenue neutrality. Among other things, no new benefit limitations should be imposed, the benefit freezes and reductions of 1982 and 1984 should be recognized as inappropriate and should be corrected, and the now almost annual exercise in adding new and complex rules should cease, pending a more deliberate and comprehensive examination of this area.

B. Protection of Core Benefits

The hazards of life remain, as always, old age, death, sickness and disability. It is essential that we retain the private sector "security net" that has developed over the past forty years for these hazards and that these core benefits be provided on a collective basis by employers rather than leaving each employee to make his or her own arrangements.

Consider for example retirement. The retirement system in this country is based upon the so-called "three-legged stool" of Social Security, private pensions and individual savings. While the Social Security system obviously needs to be maintained and individual savings should be encouraged, the most effective means of assuring an adequate standard of living for the greatest number of older Americans is to continue and strengthen the incentives for employers to provide for their employees' retirement. Employer-sponsored

retirement plans are broad-based, providing coverage to vast numbers of employees at all income levels, including those who do not have sufficient current income to cover savings in addition to basic living expenses. In addition, employer-sponsored retirement plans are generally more cost effective than individual programs, through efficiencies of scale and flexibility of investment. Moreover, they provide a chief source of capital necessary for national economic growth.

The arguments are equally compelling with respect to other core benefit programs such as health and life insurance and we should not tamper with them. This does not mean we oppose the new welfare benefit programs -- such as day care and prepaid legal services -- which respond to emerging societal needs and values. These too are important, but the point must be made that we cannot afford to jeopardize the incentives needed to assure maintenance of core benefit programs.

C. Flexibility

The third major policy value -- flexibility -- stems from, and is made necessary by, the diversity of America's employers and their workers. This necessary concept of flexibility has two different policy consequences. First, employers have different needs and abilities. For example, we now permit two basic types of qualified retirement plans: defined benefit plans and defined contribution plans. Both should be preserved for the simple reason that some employers find that defined contribution plans -- with the contribution

often expressed as a percentage of profits -- to be the more affordable of the two.

Similarly, employees should also have flexibility to provide for greater retirement benefits -- such as is permitted under so-called section 401(k) plans -- and to select, from among a menu, welfare benefits such as health and life insurance through so-called cafeteria plans. Flexibility is a key feature of current system and it ought to be retained.

To summarize, three basic policy themes underscore our present policy: voluntary choices by employers subject to reasonable non-discrimination rules, protection of core benefits and flexibility for employers and employees in tailoring retirement and benefit programs to meet individual circumstances.

III.

Specific Comments on the President's Proposals

When tested against the three principles enumerated earlier in this statement, the President's proposals represent an improvement over the so-called "Treasury I" proposals released in November, 1984. Nevertheless, we believe the President's proposals fall far short of the mark and, if enacted without change, will present a serious threat to the continued vitality and diversity of employer-sponsored pension and welfare benefit programs.

1. Uniform coverage tests

The proposed uniform coverage tests are an example of a change with meets none of these objectives. This new test, which would be applied to all qualified plans and to all welfare benefits, would require that the percentage of an employer's "prohibited group" members covered under a plan not exceed 125% of the percentage of nonprohibited group members covered under the plan. Thus, the current Code provisions in Section 410 for qualified plans would be replaced by a strictly mechanical numerical test that would eliminate the current flexibility in the coverage rules that allows commonly controlled companies with many different plans, covering groups with differing salary structures, lines of business and geographical locations to accommodate these differences in their plans without fear of disqualification. The new rules, which are explained as an attempt to broaden coverage, would go far beyond that goal and require that all such plans be uniform in their benefit levels. Employers would be precluded from fashioning benefit packages in a responsible needs-directed manner, providing certain groups of workers with greater welfare benefits and lesser retirement benefits, while allowing other groups to have higher current compensation and lesser welfare and retirement benefits.

The Administration's approach treats all employees at all wage levels, ages and occupations as fungible, and would discard the flexibility that is a hallmark of our current

employee benefits system. Moreover, because of its mechanical nature, this rule would prevent an employer from designing a plan which reasonably and appropriately replaces pre-retirement earnings on a rational basis. Legitimate business transactions would be hampered as the issue of employee benefits becomes a central focus in the decision to buy or sell a business, rather than an administrative detail to be dealt with after the transaction is consummated. Acquisitions of small companies with generous plans or high salary structures could result in the disqualification of the acquiring company's existing plans. In order to avoid that result, employers would be constrained to make prohibitively costly changes in their plans, or choose not to go forward with the transaction. The disruption caused by these new complex benefit rules could, in the long-run, be far more damaging than the abuse that the rule was designed to cure.

In light of these shortcomings, one would assume that, having considered its effects, the Administration chose to propose this change because of its enormous revenue implication. The opposite is true; this proposal raises no revenue at all. One might also think that the change is supported by clear and convincing evidence that the current rules are not working, and that the new coverage tests will result in far greater coverage at all levels. Again, a false assumption; the new tests may allow the exclusion of middle income employees in far greater numbers than is permitted under current law, thus disadvantaging middle-income employees in the benefits area in

the same way that the rest of the Administration proposal serves to do. In addition, if one assumes that the way to avoid the displacement caused by the new coverage tests is to cover all employees in a plan, that assumption would again be proven incorrect. Unless all controlled group plans have the same percentage of prohibited group members, the rules would result in widespread plan disqualification unless all plans in the controlled group were comparable.

The uniform coverage test is similarly unworkable in the welfare plan area. One can quite readily list the arguments opposing the rule based on the comprehensive list of objections raised by the Treasury in 1982 in response to a similar proposal profferred by Congressman Rangel in H.R. 6410. For example, how will one evaluate whether different benefit packages are equal? Moreover, what will the rule do to cafeteria plan arrangements, which have been so successful in allowing employees to choose the benefit package that makes the most sense at a particular age and salary level? What effect will the rule have on cost containment, an area on which Treasury and the Congress have focused so strenuously in the recent past? What about the inflexible and costly administrative burden that this rule will place on benefit plans? Having itself raised these and other issues in 1982, this Administration then concluded that the uniform coverage test was inappropriate and should be stricken from the bill.

We suggest that Treasury's objections just a few short years ago are equally apt today. The new coverage test

raises no revenue, addresses no demonstated abuse and adds needless confusion, complexity and administrative burden on a benefits system which is still struggling to understand and adapt to the new discrimination rules enacted just last year in the Tax Reform Act. Indeed, new "concentration" rules under the guise of a uniform coverage test will make provision of group life and health coverage by small employers impossible to maintain on a tax-favored basis since the rules would disqualify any plan in which more than 25% of the contributions support a benefit for the twenty most highly compensated employees. Plans covering 50 employees or fewer would almost assuredly fail to meet these new requirements.

We strongly believe that the uniform coverage test is ill-considered, and should be dropped from the current proposals and await an arena where these coverage and discrimination issues can be calmly and rationally addressed on their merits, with an opportunity for the Treasury to put forward evidence that they are indeed a necessary and appropriate change.

2. Section 401(k) plans

Initially, we were gratified to see that the President had reconsidered the Treasury's decision to repeal section 401(k) plans. However, a careful review makes it apparent that the complex rules and unreasonably reduced dollar limits of the Administration's proposals are simply another way of eliminating these valuable retirement programs. The

coverage and discrimination tests proposed by the Administration are inordinately complex and will add immeasurably to the administrative costs of maintaining these plans. The penalty for failure to meet the tests will fall on an individual employee, who will be liable for a penalty tax for a violation that he or she is in no position to monitor. Moreover, as the dollar limit for salary deferrals is reduced, those tests become entirely unnecessary. If the decision is made that these plans will be retirement vehicles only, and no withdrawals will be permitted prior to retirement, then the dollar limit at $8,000 solely serves to create a disincentive to saving, when this result is precisely the opposite of the Administration's expressed goals.

3. Proposals Relating to Savings Plans

This disincentive to savings is further illustrated by other proposals made in the Administration package, the net effect of which will discourage employee participation in thrift plans. Under the proposal, contributions to all tax-favored plans will be required to remain in the plan until retirement; the penalty for early withdrawal will be an excise tax equal to 20% of the distribution, except in very limited circumstances. Even at retirement, distributions will be treated as a return of taxable earnings first, rather than a return of previously taxed employee contributions. Thus, employees will be reluctant to contribute to a plan in the first instance, when the penalty of removal of funds in times

of need is so severe. Even where an employee determines that a distribution is critical, the excise tax and the tax treatment of the distribution combine to powerfully discourage contributions by employees at all. Moreover, the changes in the treatment of employee contributions under Section 415 make voluntary contributions by middle and upper level employees more difficult as well. While any individual change might be explained or even thinly rationalized by the Administration, the total effect is anti-savings. Far worse, the long-term effect is lesser private resources at retirement for all employees, a result this Committee must act to prevent.

IV.

Conclusion

We are moving, inexorably, toward a system which is so expensive and burdensome for employers to maintain that they will choose to opt out entirely, simply increasing current compensation and allowing employees to purchase welfare benefits and to save for retirement on their own. The efficacy of employer-sponsored group benefits has already deteriorated and the system is reeling with repeated changes of the rules in almost every legislative session in past memory. As employers become unable to provide qualified plans at appropriate levels for their key employees, they will choose to provide these benefits in non-qualified arrangements. Thus, benefits for the rank and file will be reduced, if not eliminated. As we have

pointed out before, the benefits programs of American industry are not endlessly elastic; after some point, employers will choose not to provide these benefits and the burden will ultimately fall on the government to ensure that the welfare and retirement needs of American workers will be met. The changes suggested by this Administration need to be carefully reviewed for the disincentives they create, rather than for their revenue implications and their administrative ease on the government. Ease of enforcement is laudable but not a goal in and of itself; short-term revenue enhancement can easily and quickly be eclipsed by larger and more costly burdens on the government to provide for the old and ill. If tunnel vision and shortsightedness have characterized the Administration's view of the changes necessary in employee benefits, we urge the Congress not to fall into a similar trap. The needs of employees will not diminish in the future. The only aspect of employee benefits likely to change is an employer's willingness to suffer repeated change and expense to meet these employee needs.

STATEMENT OF WALTER HOLAN, PRESIDENT, PROFIT SHARING COUNCIL OF AMERICA, CHICAGO, IL

Mr. HOLAN. Thank you for the opportunity to appear here. I am here to explain profit-sharing plans in general, and I have filed a supplemental statement which covers some of our objections to the proposals in the Tax Reform Act. There really isn't enough time to cover both areas at this time. In profit sharing, the greater the profit, the greater the retirement income.

Profit sharing and employee stock ownership plans are the only two types of benefit plans that allow the employees to share in the profitability of the corporation. Thus, the employees can affect their retirement income. The incentive aspects of profit sharing are too often ignored in looking at the Tax Code. The retirement aspects are emphasized, but the incentive aspects are ignored. The greater the investment return, the greater the employee's retirement account. Conversely, the employee suffers the risk of adverse returns. There is very little integration in profit-sharing plans. This is particularly important to low paid employees. Where there are forfeitures from departing employees, these go to other employees. They are rarely used to reduce employer contributions.

Most profit-sharing plans have graduated vesting that is much more liberal than those in defined benefit plans. Many plans vest at 10 percent a year or even earlier. In today's mobile society, this is particularly important. The combination of early vesting and lump-sum payouts enables mobile employees to roll over their amounts into an individual retirement account or other employer plan for retirement. Profit-sharing plans have security. If the plan is terminated, the employee's account is fully vested and payable to him or her. There can be no reversion of assets, nor does the employee have to look to PBGC for a guarantee. There is full vesting at death or disability, regardless of age or regardless of service. This is important to surviving spouse or children; 60 percent of our plans have savings features, and these offer the participant an easy way to save and to have the taxes on the investment earnings deferred.

On these savings, the participant receives professional investment services at the least possible cost. Today we have flexibility of payout at retirement, and this flexibility enables the retiree to choose a lump-sum distribution, installments, or annuities. Through these flexible payouts and varying tax treatments, the retiree is in a position to make conservative investments to keep pace with inflation.

For example, Treasury bills have generally kept pace with inflation in recent years. Retirees need not depend on an employer for ad hoc increases. The employer may not be able to afford such increases, or the employer may even be out of business. What are the advantages of profit sharing to employers? A number of studies have indicated that profit sharing companies are profitable than nonprofit-sharing companies, which time won't permit me to detail. Needless to say, increased profitability is important for more reasons than retirement income alone. Such profitability ensures continuance of the company, the job, and also generates increased tax revenues for the Government. Another advantage to the employer

is that contributions are made from current or accumulated profits. If there are no profits, ther are no contributions. This can be important to an employer whose profits fluctuate from year to year, particularly in the small business area.

For such a company, the fixed commitment required by a defined benefit plan, the need for the company to fund adverse investment results and the continuing actuarial costs may cause a great hardship to the company, not to mention the additional costs of the PBGC premium. The two disadvantages of profit-sharing to employees are the lack of profits or minimum profits to be contributed to the plans and the risk of investment losses. However, if a company is unprofitable, it is doubtful it could afford any type of retirement plan. Possibly, the major disadvantage to a profit sharing plan is that the investment risk rests with the employee. However, a number of studies that we have conducted over the years have shown that profit-sharing plans are investing more and more in conservative investments and offering such type investments to the employees.

Guaranteed investment contracts, for example, according to our studies, now represent some 15 percent of the total profit-sharing assets among our members. Even on retirement, the employee has an opportunity to recover some of the investment risk. For example, if he retires when the market is at a low ebb, he can either leave his balance in the profit-sharing plan and receive installments, which will grow with market recovery, or he can roll the lump sum into an IRA fund invested in the equity market. Neither of these is a perfect solution, but they do offer some opportunity in the event of investment risks. Again, I would emphasize to you that the incentive aspects of profit sharing must not be overlooked in any legislation that is proposed. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Cohen, it is good to have you with us again.

[The prepared written statement of Mr. Holan follows:]

Testimony of
Walter Holan
President
Profit Sharing Council of America
on
The Impact of the Tax Reform Proposals
on Profit Sharing Plans

July 11, 1985
before
Senate Committee on Finance

The Profit Sharing Council of America is a non-profit association of approximately 1300 American employers who maintain profit sharing plans. Deferred profit sharing plans will be the sole or primary private source of retirement benefits for a very large segment of today's working men and women. There are approximately 360,000 deferred profit sharing plans in the United States today covering over 20 million employees. The legislation you are considering will be a fundamental determinant of how much of their accounts' accumulation will remain after taxation to actually provide retirement security, and how much flexibility will be allowed for each person to exercise individual judgment in the use of his or her profit sharing distribution.

Profit sharing is an incentive system and productivity booster whose design, application and approach differs according to the needs and problems of individual firms. When employees become profit conscious, friction eases, production spurts, costs drop and profits rise. Profit sharing promotes and sustains morale, interest, allegiance and loyalty on the part of employees. When management intelligently shares profits, the company prospers, the stockholders prosper, the employees prosper and the nation prospers. Many of the tax reform proposals do not seem to take these incentive factors into account, but concentrate only on the retirement aspects of profit sharing.

In 1939, the Vandenberg-Henning Subcommittee of the Senate Finance Committee conducted an intensive study of profit sharing plans and concluded: "We believe it (profit sharing) to be essential to the ultimate maintenance of the capitalistic system." Partly influenced by these favorable findings, Congress passed legislation providing tax advantages for qualified, non-discriminatory deferred profit sharing plans. Over the years, legislation affecting profit sharing has had two primary objectives: first, to see that participant's rights and accounts are protected, and, second to prevent discrimination in plans.

The new tax proposals, however, represent a sharp departure from Congressional practice, are an intensive attack on profit sharing plans, and reflect a lack of understanding as to how such plans operate. We strongly urge the Committee to reject all those proposals which have an adverse affect on profit sharing.

Profit sharing is that rare and happy creation that offers rich benefits to both employer and employee. It is an incentive for increasing productivity and decreasing costs; it provides retirement security; it delivers benefits in the event of disability, death or employment termination prior to retirement; it helps attract and retain quality personnel; most importantly, it shares the rewards of the free enterprise system broadly throughout the organization.

The tax proposals ignore the fundamental differences that separate the two principal retirement plans. With profit sharers, if there is no profit, there is no profit sharing ccontribution. Profit sharing amounts are allocated irrevocably to vested participants' accounts where the assets are accumulated at market risk until they are ultimately delivered to the participant (or beneficiary) usually at retirement. This is in stark contrast to a defined benefit pension plan which promises a set periodic payment after retirement, regardless of the profitability of the employer. Investment losses or gains affect only the employer's funding.

Despite these differences, the proposals insist on treating all retirement plans alike on the basis that these plans are related in "concept and purpose." Profit sharing (and Employee Stock Ownership Plans) are the only employee benefits that can realistically motivate employees to greater productivity by offering a share of the fruits of progress. Defined benefit pension plans have no incentive value, for they are only a conditional promise to deliver a future benefit. Thus, the concept and purpose differs markedly.

Our 1983 survey of profit sharing plans showed that 20% of members responding made an employer contribution of an amount less than 3.5% of pay. Of those companies, almost two-thirds had fewer than 300 employees. Annual profits of smaller companies tend to fluctuate more than those of larger companies. Yet, the proposals on employer deductibility would eliminate the carryover provisions which permit companies in good years to put additional amounts into participant's accounts to balance off the years in which no contributions or smaller contributions were made. Statutory prohibition of carryover provisions would lend a "heads you win, tails I lose" flavor to profit sharing plans at such firms. Most important of all, it would reduce the employee's retirement benefit, surely a goal no one intends.

The annual limit on the amount which can be contributed to each individual's account would have another extremely adverse affect. A number of profit sharing plans allocate on the basis of service as well as compensation. This feature rewards employment longevity and accelerates growth in the accounts of individuals approaching retirement. This is particularly important in bringing low-paid individuals to an adequate level of retirement security. But the Treasury proposals would severely inhibit this practice, which has been a principal element of some of the nation's oldest and most successful profit sharing plans.

The deductibility and individual limit proposals will insure that if a company is successful in motivating its employees to greater profits, employees will <u>not</u> fully share in this profitabiliy.

The new rules on withdrawals from profit sharing plans would severely limit savings in profit sharing plans, particularly by younger employees. Several years ago, when Individual Retirement Accounts became available for private plan participants, a number of our member firms with voluntary non-deductible savings plans suggested their employees convert these savings to deductible IRA contributions within the plan. But when young employees discovered the withdrawal restrictions and penalties before age 59½, they weren't interested in converting. They stayed with their old non-deductible savings plan because of the availability of these funds in an emergency. New proposals would impose smilar restrictions or penalties on in-service withdrawals from profit sharing plans. And we predict young people will again simply not save money that is not reasonably accessible. We feel it is extremely important that young people save in their profit sharing plans because the compounding effect of these extra funds over 20 or 30 years provides the boost that insures a secure retirement lifestyle. The encouragement of thrift, in our opinion, is much more important than the correction of any minor abuses which may occur in this area.

The abolition of 10-year averaging and capital gain taxation for lump sum distribution and unrealized appreciation exclusion on distributed employer stock ignores the fact that profit sharing participants' accounts are "at risk" and have typically been built up over 20, 30 or 40 years of ups and downs. Lump sum distributions are taken primarily by low- and middle-income individuals and not by higher paid executives. Normally, executives will roll over their distributions for tax and estate planning reasons.

Employees in the lower or middle class often take lump sum payments to pay off the mortgage on a home, to move to a more favorable climate and purchase a retirement home, to have funds for costly medical care, and to make investments with remaining money to maintain the level of his or her economic security in retirement.

The proposal does allow the participant to rollover his or her distribution into an Individual Retirement Account. In fact, it virtually forces the individual to do so. Those who object to allowing participants to receive a lump sum seem to have no confidence in the ability of the American worker to handle his or her own funds in retirement. In the Council's many years of experience, the great majority of participants in profit sharing plans want and take lump sum distributions and we have never heard of one instance in which a lump sum given at retirement has been squandered by the participant. If such events were to occur, I am sure that Council members would see to it that profit sharing payments were made on an installment basis since they, too, are concerned with the needs of their retiring employees.

If the tax proposals become law, an employee nearing retirement with a profit sharing account built with sweat and diligence over a quarter-century or more will learn that an unappetizing choice must be made at the time of the account's lump sum distribution: pay high taxes and maybe penalties, or roll it over into an Individual Retirement Account.

While a rollover IRA can be a highly beneficial device when it is freely selected by an individual who has considered all alternatives, it is not a miracle solution to every retiree's financial management requirements, particularly if that retiree is younger than 59½. Or if the retiree and the IRA are joined in a shotgun wedding.

Those individuals who receive employer stock at retirement are particularly harmed by these proposals. First, should they decide not to rollover, they are taxed at the market value of the stock, even though they have not sold the stock. They have borne the same risk as any other investor, yet they are taxed on a discrimination basis. The individual investor only pays tax on unrealized appreciation when the stock is sold. Second, to pay the tax, the individual must sell all or a portion of the stock. This decision may be forced when the price of the stock is low. Many plan participants who now receive employer stock anticipate keeping such stock at retirement, living on the dividends, and selling the stock at a time they choose. If they are forced to rollover their stock, not only do they lose this retirement flexibility, they will face additional charges in the rollovers. The institution that receives the rollover will not do so as a public service. It will be a bank or stockbroker or other profit-making enterprise which will charge trustee fees, or investment management fees, or brokerage fees.

The new non-discrimination rules for tax favored retirement plans have been designed because the old rules created situations where, according to the proposals, discrimination was resolved on the "basis of the facts and circumstances in each case." The new tax proposals supposedly create non-discrimination tests which provide greater certainty. In fact it does just the opposite. They are complicated and no one seems to understand them fully. Parenthetically, it seems ridiculous under one test to call an individual making $20,001 "highly compensated."

Instead of the present non-discrimination rules under which coverage must be given to a "fair cross-section" of employees, a new rule has been substituted. Under this rule the percentage of participation by the top 10% of employees cannot exceed 125% of the participation of the bottom 90%. A controlled group of corporations is treated as one employer.

In some situations, if a disproportionately large percentage of the higher paid employees work for a particular company, that company's plan may not qualify even though all of its employees participate in the plan. Companies set up their plans to be competitive with similar companies in the same industry. Thus, plans are not necessarily uniform among different companies in the same controlled group. Certainly where a profit sharing plan covers all or nearly all of the employees in a specific company or in a particular industry it should qualify as non-discriminatory.

We feel the current eligibility rules have served well in seeing that all classes of employees receive benefits in profit sharing plans. They have provided more certainty in their application than the proposed rules would provide. If there is anything to be said against the current rules, it is the application of the "top heavy" rules which remain in existence under these proposals, and they are extremely burdensome to small businesses.

In recent years, many companies, including numerous profit sharing companies, have adopted 401(k) plans. They have spent literally millions of dollars setting up and promoting such plans to their employees and the employees have responded enthusiastically. The new proposals would impose new and complex non-discrimination rules, and rules affecting both deferral percentages and matching contributions. These proposals would reduce the amount of employee savings and create an administrative nightmare to see that the rules are followed.

In conclusion, the tax proposals affecting profit sharing are not fair. They will inhibit economic growth rather than promote it, and its authors have publicly admitted the goal of simplicity has been abandoned. If you wish to promote and encourage profit sharing as an important weapon in the "maintenance of our capitalistic system" we urge you to drop these ill-conceived proposals.

Supplemental Statement of
Walter Holan
President
Profit Sharing Council of America
on
Profit Sharing Plans as A
Retirement Arrangement Best Suited
to Today's Work Force

The Profit Sharing Council of America (PSCA) is a non-profit association of approximately 1,300 employers who maintain profit sharing plans. These plans cover approximately 1,750,000 employees. Council members are located throughout the United States and are engaged in practically all areas of economic activity. Member companies range in size from Fortune 500 size companies down to very small businesses.

Some of the material presented in this statement comes from the Profit Sharing Research Foundation (PRSF), Evanston IL, a non-profit publicly supported research and educational foundation.

Profit sharing is an incentive system and productivity booster whose design, application and approach differ according to the needs and problems of individual firms. When employees become profit conscious friction eases, production spurts, costs drop and profits rise. Profit sharing promotes and sustains morale, interest, allegiance and loyalty on the part of employees. When management intelligently shares profits the company prospers, the stockholders prosper, the employees prosper and the nation prospers. These factors should be kept in mind when considering legislation affecting such plans. Much of the emphasis we see today is geared to the retirement aspect of profit sharing alone, without due consideration of its contribution to the economic well-being of the nation.

Deferred profit sharing plans are or will be the primary private source of exceptional retirement benefits for millions of retirees and employees whose efforts during their working lifetimes contribute to the success of thousands of U.S. companies which elect to share their profits with their employees. There are approximately 360,000 deferred profit sharing plans in existence. These plans cover

approximately 20 million employees and we estimate these plans have assets of well over $175 billion.

Profit sharing plans are usually established with one or more of the following objectives:

- to provide retirement income;
- to deliver benefits in the event of disability, death or employment termination prior to retirement;
- to create an incentive for increasing productivity and decreasing costs;
- to accumulate savings for employees, which contribute to capital formation; and
- to attract and reward employees by sharing the profits of the free enterprise system broadly throughout the organization.

Deferred profit sharing plans provide participating employees with special sums of money placed in trust, in addition to their pay at prevailing rates. These extra payments are based on the profits of the employer and generally average 8% to 10% of payroll, but can range up to 15%. In recent years employee savings in plans have dramatically increased through voluntary and mandatory employee contributions and through cash or deferred arrangements under Section 401(k).

A large majority of plans offer options to participants as to how and when their accumulated profit sharing accounts are distributed at retirement. Generally the account is distributed in a lump sum. Many plans also allow the retirees to receive their account balances in annual installments or the plan may purchase and distribute an annuity contract. If the participant dies while employed, the full account balance is distributed to the designated beneficiaries, regardless of service requirements for vesting. Some plans permit partial withdrawals or loans during employment, in hardship situations. Plans usually provide for limitations on partial withdrawals and loans to prevent the participant's retirement security from being jeopardized.

A number of profit sharing plans also invest in stock of the employer. In this way the employee not only shares in the profits of his employer, but is also given a proprietary interest in the success of his employer. In this way the employees are made true partners in the employer's business. This stock is often distributed to employees at retirement and permits them flexibility in meeting their retirement needs.

One of the chief objectives of most profit sharing plans is to provide an accumulation of retirement capital for the employee and not necessarily a form of fixed annuity income. This capital makes it possible for retired employees to maintain the flexibility needed to meet changing conditions during their retirement years. For example, in addition to providing retirement living expenses, a profit sharing lump sum payment allows the retired employee to pay off the mortgage on a home, to move to a more favorable climate and purchase a retirement home, to have the funds for costly medical care and to make investments to maintain the level of his economic security in retirement.

We have witnessed the debilitating effects of inflation. We have seen that a more-than-adequate pension, as judged by standards 25 years ago, will not even meet today's test for determining the poverty level. We believe it is most unfair to force an employee to receive his profit sharing accumulations in an annuity or a similar fixed type of periodic retirement payment and thereby subject these funds to the eroding effect of inflation and depreciation in the purchasing power of the dollar. A lump sum payment gives the employee the flexibility to protect himself or herself against this risk.

Those who object to allowing participants to receive a lump sum seem to have no confidence in the ability of the American worker to handle his or her own funds in retirement. In the Council's many years of experience the great majority of participants in profit sharing plans want and take lump sum distributions and we have never heard of one instance in which a lump sum given at retirement has been squandered by the participant. If such events were to occur, I am sure that Council

members would see to it that profit sharing payments were made on an installment basis since they, too, are concerned with the needs of their retiring employees.

Profit sharing is a superior mechanism for delivering enriching financial benefits to participants in every level of the American economic structure. This is possible because of the following facts, which are characteristic of virtually all profit sharing plans:

- Increased profits produce increased retirement income potential, thus enabling each individual to enhance his or her future security.
- Immediate or speedy vesting common in profit sharing creates early non-forfeitable benefits which become the building blocks of economic independence.
- Fast vesting and lump sum distributions permit employees who don't retire to continue retirement-security building programs by rolling account balances into Individual Retirement Accounts or retirement programs of new employers.
- Departing members' forfeitures are spread among remaining participants; very rarely are they used to reduce employer contributions.
- Participants -- never the plan sponsor -- receive the fruits of successful investment of plan assets. Because the participant is "at risk" many plans offer investment options that permit each person to select the fund which offers the elements which most appeal to him or her at each decision-making time.
- Profit sharing plans that are "integrated" with Social Security are extremely rare. This means that profit sharing benefits to lower-paid participants are not reduced by an amount related to the expected Social Security benefit.
- Terminated plan assets go fully vested to participants. None revert to the employer. Nor is there any involvement of the Pension Benefit Guaranty Corporation.

- Regardless of age or service, accounts of profit sharing participants who die vest fully and are delivered promptly to beneficiaries, usually in the form desired. Disability also brings unqualified full vesting.
- Most plans now permit participants to further enhance their future security by contributing their own money to their account through payroll deduction. Two additional advantages result: "free" professional management of these savings, and tax deferral on the earnings generated.
- Variety of distribution options at retirement (lump sum, installment, annuity) plus rollover capability to IRA, give maximum flexibility for each individual to utilize the method best suited to his or her own needs.
- Favorable taxation at distribution (or further tax deferral on rollovers) means that maximum net proceeds are available for meeting each person's retirement financial requirements.
- Because the retiree upon distribution owns and controls the assets, he or she has unlimited opportunity to take steps to offset the inroads of inflation, pay off the mortgage, move to a retirement residence, or otherwise exercise judgment in matters relating to one's own well being.

We believe that the advantages cited will continue to provide superior economic security to American workers covered by profit sharing plans.

Some objections have been raised to the ability of plan participants to withdraw voluntary savings in profit sharing plans. However, if these withdrawals are prohibited or severely restricted, participants -- particularly younger participants -- will tend not to save, thus diminishing the pool of savings which can be used for retirement in future years. The fact that some of these withdrawals may be used for non-retirement purposes is no reason for eliminating the withdrawals and thereby discouraging younger employees from saving through their profit sharing plan.

We believe that the unique benefits to be derived from profit sharing should not be sacrificed to patronizing zeal in protecting the employee by prescribing still another uniform annuity system and restricting the ability of the American worker to handle his or her own money in a way he or she determines suitable.

STATEMENT OF EDWIN S. COHEN, PARTNER, COVINGTON BURLING, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. COHEN. Thank you, Mr. Chairman. I am Edwin S. Cohen, a member of the law firm of Covington Burling of Washington, and I am here this morning before the committee on behalf of the Investment Company Institute, the national association of the mutual fund industry. The institute's membership includes 1,140 open-end investment companies, known as mutual funds, investment advisors and their principal underwriters. The institute's mutual fund members have assets of approximately $378 billion, representing about 90 percent of total industry assets, and they have over 20 million shareholders.

Mutual funds have traditionally served as a vehicle through which investors of modest means may channel their investment dollars into the Nation's economy through a diversified, professionally managed, pool of investments. It also serves as the investment medium for retirement programs, including those established by employers and by the self-employed and section 401(k) plans, but particularly in recent years, to individual retirement accounts.

If I may, I should like to focus on the major contributions that the IRA has made to the Nation's private retirement program, as shown in a survey that was made last year by the institute. These figures may differ somewhat from those that have been earlier presented today, I think particularly by Mr. Smith because I believe the survey to which Mr. Smith referred was conducted in 1982, and that survey by the institute was conducted in 1984.

The IRA's were introduced by ERISA in 1974, and they were simplified and made available to all workers in the 1981 act. At the time that change occurred, the total IRA assets were about $26 billion. By the end of 1984, according to the survey, they had grown to $132 billion, more than five times as much, and that amount was owned by some 23 million households. We estimate now that by this time thay have risen to the neighborhood of $175 billion.

The IRA's provide for individuals an unfettered freedom of investment choice beyond that which is available in employer provided retirement and savings programs. Our written statement that we have filed shows how widely these choices have been utilized by the account holders. The institute believes that the IRA as expanded in 1981 to provide universal coverage for all workers is a unique, simple, and effective retirement savings vehicle. It should remain so.

In my written statement I call attention to the fact that one of the various administration proposals regarding retirement savings would impose new dollar limits on contributions to 401(k) plans and would reduce those limits by the amount contributed to an IRA. We believe this would produce an unfortunate complexity that was eliminated by the 1981 legislation, and that the proposed offset of IRA contributions against 401(k) contributions limits would impede the continued growth and development of the program. We do not believe that the two programs should be intertwined.

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The institute supports the proposal to increase the permitted contributions for spousal IRA's.

And Mr. Chairman, there were a number of questions asked of previous panels this morning, and I hope to have the opportunity to make some observations regarding some of that dialog, if I may, on behalf of the institute; but further, without speaking for the institute, since I have been involved in this field both in private practice and in the Treasury for some time, I have a few comments I would like to offer. I was present at the birth of the 401(k) plans in 1953 and at the birth of IRA's in the early 1970's. So, if I may later, I should like to offer a few comments.

[The prepared written statement of Mr. Cohen follows:]

TAX REFORM AND ALTERNATIVE RETIREMENT ARRANGEMENTS

SUMMARY OF PRINCIPAL POINTS IN

STATEMENT OF EDWIN S. COHEN

ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SENATE COMMITTEE ON FINANCE

July 11, 1985

1. Mutual funds have traditionally served as a vehicle through which investors of modest means may channel their investment dollars into the nation's economy through a diversified, professionally managed pool of investments. They have also served as the investment medium for retirement programs, and particularly in recent years for individual retirement accounts (IRAs).

2. The IRA was introduced in ERISA in 1974, and simplified and expanded in 1981. A recent survey conducted by the Investment Company Institute shows that they have grown from $26 billion at the beginning of 1982 to $132 billion by the end of 1984, and are estimated now at almost $175 billion. They are owned by some 23 million households, two-thirds of which have incomes under $40,000. The Institute estimates that IRAs added some $14 billion to new savings in 1983, and probably more than $17 billion in 1984.

3. The IRA provides for individuals an unfettered freedom of investment choice, beyond what is available in employer-provided retirement and savings programs, and the choices have been widely utilized between various investment mediums, as noted in the statement on page 6.

4. The IRA is a unique, simple and effective retirement savings vehicle, and should remain so. One of the Administration's proposals which would impose new dollar limits with respect to contributions under so-called cash-or-deferred arrangements (section 401(k)) and which would reduce those limits by any amounts contributed by an employee to an IRA, would produce an unfortunate complexity that was eliminated in 1981. The Institute believes that proposal would impede the continued growth and development of the IRA program, and urges the Committee not to adopt that proposal.

5. The Institute supports the Administration's proposal to increase the permitted contribution level for spousal IRAs.

TAX REFORM AND ALTERNATIVE RETIREMENT ARRANGEMENTS

STATEMENT OF EDWIN S. COHEN
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON FINANCE
July 11, 1985

I am Edwin S. Cohen, a member of the law firm of Covington & Burling, of Washington, D.C. I appear before the Committee today on behalf of the Investment Company Institute, the national association of the mutual fund industry. I have been counsel to the Institute for a good many years. With me today are Alfred Johnson, Vice President and Chief Economist of the Institute, and Catherine Heron, Associate General Counsel for Tax at the Institute.

The Institute's membership includes 1,140 open-end investment companies ("mutual funds"), their investment advisors and principal underwriters. The Institute's mutual fund members have assets of approximately $378 billion, representing about 90 percent of total industry assets, and they have over 20 million shareholders.

Mutual funds have traditionally served as a vehicle through which investors of modest means may channel their investment dollars into the nation's economy through a diversified, professionally managed pool of investments. They have also served as the investment medium for retirement programs, including those established by employers and by the self-employed, and particularly in recent years, for individual retirement accounts (IRAs).

I should like first to focus on the major contribution that the IRA has been making to the nation's private retirement program, as shown in a survey of IRAs conducted this past year by the Institute.

IRAs were introduced by the Employee Retirement Income Security Act (ERISA) in a limited form in 1974. They were simplified and made available to all working individuals as of the beginning of 1982. At that time the total pool of IRA assets consisted of only $26 billion. By the end of 1984, the survey shows, the pool had grown to $132 billion, more than five times as large, and that amount was owned by some 23 million households. The Institute estimates that the total IRA pool by the end of April 1985 amounted to almost $175 billion.

The positive impact of the IRA on savings for retirement stems from two primary sources: (1) reinvested earnings generated

by the expanding pool of assets just described, and (2) saving out of current income. At the beginning of 1983, for example, outstanding IRA assets totalled $52 billion. If we assume that these assets earned a nominal 8.0 percent, approximately $4.2 billion of new savings were generated during that year. In addition, the Institute determined from its survey of the IRA market, that IRA owners -- through their 1983 contributions out of current income -- added $10 billion to savings that would not otherwise have been made and that, in the absence of IRAs, would have been spent. In total, the Institute estimates that IRAs added about $14 billion to new savings in 1983. The comparable number for 1984 is probably over $17.0 billion.

The growth of the accumulated IRA pool has a multiplier effect. As total IRA assets grow, new savings from earnings on these assets also grow. For example, the Institute further calculated that the new addition to savings from earnings on the IRA asset pool may be as much as $37.0 billion dollars in 1989. These figures are based upon a projection that IRA assets could reach $550 billion or more by the end of the decade. This estimate is large even though the assumptions underlying it are quite conservative. The following chart summarizes the savings data:

NEW SAVINGS GENERATED
FROM IRA ASSETS
(Billions of Dollars)

YEAR	IRA ASSETS	NEW SAVING GENERATED FROM ASSETS*
1981	$ 26	---
1982	52	2.1
1983	92	4.2
1984	132	7.4
1989	550+	37.0

(ESTIM.)

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* Assumes earnings on IRA assets at the end of the previous year will grow by an average of 8.0 percent.

The Institute's survey has demonstrated that the IRA must, in the future, be recognized both for its importance in promoting economic security in retirement as well as its accelerating contribution to capital formation. To further enhance retirement savings and capital formation, the IRA contribution limits should be increased. For this reason, the Institute heartily endorses

the proposal in the Administration's tax reform package which would increase the spousal IRA contribution limits from $2,250 to $4,000 each year. This proposal would eliminate the existing discrimination against non-working spouses under current law and would permit both families with one wage-earner and those with two wage-earners to contribute as much as $4,000 each year to IRAs.

The Institute believes that the IRA, as expanded in 1981 to provide universal coverage to all wage earners is a unique, simple and effective retirement savings vehicle. The IRA may be easily understood and established with a minimum of paperwork and red tape. It is significant to note that of the 23 million households which own IRAs, the Institute survey shows that two-thirds of these households have incomes under $40,000.

Moreover, under its current structure and rules, IRA accountholders have complete freedom of investment choice. The Institute's survey shows that IRA participants have exercised this freedom of investment choice through a variety of financial institutions offering a broad selection of investment products. The IRA market share breakdown at the end of 1984 is widely diversified:

INSTITUTION	PERCENTAGE
Commercial Banks	28.1
Mutual Savings Banks	6.4
Savings and Loan Associations	24.8
Life Insurance Companies	10.6
Credit Unions	5.9
Mutual Funds	12.1
Direct Investment in Stocks and Bonds	12.1

In contrast to the freedom of investment choice found in the IRA, the investment choice in employer-provided retirement and savings programs is more limited. In these programs, it is the employer who typically designates a single investment medium or institution or who permits his or her employees to select from a limited choice of investment media.

Unfortunately, the freedom of investment choice, which sets the IRA apart from other retirement savings programs and, indeed, the continued growth of the IRA asset pool itself, is threatened by one of the proposals contained in the Administration's tax reform package. This proposal would require that an individual covered by an employer's section 401(k) plan, a so-called cash or deferred arrangement, would have to offset his IRA contributions against the maximum dollar limitation on elective contributions

which could be made to the 401(k) plan. In effect, many wage earners would be forced to choose between contributing to an IRA or having a larger contribution made to their employer's 401(k) plan.

The Institute opposes this type of offset provision as an unwarranted interference with the IRA which would have the ultimate effect of reducing IRA contributions. In addition, the 401(k)-IRA offset proposal strikes at the unfettered freedom of investment choice which is currently available to IRA participants. The offset proposal constitutes a type of governmental intervention which might permit an employer to skew the investment choice to the more limited selections offered under an employer's 401(k) plan. Moreover, a relatively simple, ease-to-administer retirement savings program represented by the IRA would, of necessity, become burdened with a new set of complex rules and cross-reporting requirements necessary to determine the amount of permissible IRA and 401(k) contributions for a particular year. An important feature of the 1981 amendments to the IRA provisions was the elimination of the previous linkage between the availability of an IRA to an individual and his eligibility under other retirement programs, resulting in a great simplification of the IRA procedures. A currently simple, uncomplicated program would once again become burdened with unnecessary paperwork and uncertainty.

This direct blow to the IRA savings program apparently has been justified as being part of a package to deal with issues involving 401(k) plans. But the imposed linkage between IRAs and 401(k) plans is not a rational response to the perceived 401(k) problem.

To the extent that there may have been a concern that the non-discrimination coverage standards imposed upon section 401(k) plans have not been fully effective, the Administration's proposals would substantially revise and tighten these standards. Similarly, to the extent that there may have been a concern that 401(k) plans were used for short-term savings rather than retirement purposes, the Administration's package would restrict the use of loans and early distributions from 401(k) plans and other types of tax-favored retirement arrangements.

Unfortunately, the Administration's proposals would go beyond revision of rules pertaining to section 401(k) plans to impose special maximum dollar limits on the amount an employee may elect to have his employer contribute to a section 401(k) plan for his benefit, and to link those proposed limits to the amount an employee may have contributed in the same year to an IRA reducing the amount available for the employer's 401(k) contribution by the amount the employee contributed to the IRA. The Institute urges that any legislation addressing section 401(k) plans not include such a limitation.

The Institute believes that our present private retirement legislation, as it has been amended on several occasions in recent years, has served the nation very well indeed. As supplements to the social security program, privately funded retirement programs have made a marked contribution to the maintenance and security of the elderly. IRAs are a major part of this network and will increase in importance as the years pass. Flexibility in the types of retirement programs should continue to be encouraged, with the objective of enabling as many working individuals as possible to be covered.

This area of the law is a complex and delicate one. While it is deserving of periodic review, frequent changes become confusing. A number of the Administration's proposals regarding retirement programs seek to achieve greater uniformity of treatment between various types of plans, and broadly speaking this would seem desirable. But many of the proposals are stated in general terms without specifics that are important to an under standing and appraisal of the proposals. We would urge the Committee to proceed with due deliberation and allow adequate time for public comment after legislative drafts are available, even if that should require that some of the proposals be deferred for later legislation.

INDIVIDUAL RETIREMENT ACCOUNTS HELP BOOST SAVING IN THE U.S.

MAY 15, 1985

ALFRED P. JOHNSON
VICE PRESIDENT &
CHIEF ECONOMIST
INVESTMENT COMPANY INSTITUTE
WASHINGTON, D.C.

In 1981 Congress enacted legislation broadening the eligibility criteria governing individual retirement accounts (IRAs). All taxpayers with earned income became eligible to participate in the program. One of the goals of this change was to help promote economic security in retirement, a national policy objective since enactment of the Social Security Program in 1935. Another key goal was to increase the volume of saving.

The rate of saving in the U.S. is low relative to savings rates in other industrial countries throughout the world (Table I). It is also low relative to our continuing need to encourage capital formation and to finance a continuing huge volume of public and private debt. Public policies designed to increase long-term saving would, therefore, help to keep inflation and interest rates at acceptable levels and stimulate growth in investment, production, and jobs.

It was quickly apparent that the new IRA program would enhance the retirement income of many individuals in low to moderate income groups. In contrast, the magnitude of the impact of IRAs on saving was not immediately evident. Now well into the fourth year of the expanded IRA program, however, its current and prospective contributions to saving are becoming clear. IRAs <u>have</u> boosted saving in recent years and their contribution to saving will accelerate in the years ahead.

MEASURING THE IMPACT
OF IRAS ON SAVING

IRA contributions to saving stem from two primary sources: (1) current income, and (2) reinvested earnings generated by the expanding pool of IRA assets. It should be emphasized at the outset that our estimates of the impact of IRAs on saving are not based on inferences drawn from changes in aggregate saving nor from variables only loosely related to such saving. Rather, they are derived from data which bear directly on activity in the IRA market.

Net Saving Out Of Current Income. The premise that IRAs have prompted people to save more out of current income is substantiated by data compiled in a survey of the IRA market conducted last November.* In that survey, respondents were asked a variety of questions relating to IRAs. One sequence of questions was specifically designed to help quantify the impact of IRAs on saving.

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*The survey was conducted for the Investment Company Institute by Market Facts, Inc., a major market research firm. Approximately 5,000 questionnaires were mailed to a representative group of households and 3,487 were returned. Of that latter number, 965 were IRA owners and 2,522 were non-owners. The response rate was a high 70 percent and the income and age distributions of the sample closely match those of the U.S. population.

The first step was to estimate the sources of money used to finance IRA contributions in tax year 1983. The crucial element in this exercise is the need to distinguish IRA contributions which come from current earnings or other current income from those financed out of prior savings. To help insure accurate answers, respondents were instructed not to count dollars as prior savings if they came out of current income but were temporarily placed in checking accounts or other forms of saving during the year. Rather, such "pass throughs" should be regarded as current income.

When the responses were tabulated, we found that almost 6 in 10 respondents said that some part of the money contributed to their IRAs in the 1983 tax year came from current income. The balance came from different types of prior saving.

It is not enough, of course, to simply estimate the percentage of owners who said they used saving out of current income to finance their IRA contributions. If, for example, these contributions were simply a substitute for another type of saving, there would be no net addition to personal saving. In order to clarify this point, respondents were also asked: "had you not put your money in an IRA during the 1983 tax year, how would the money have been used?"

The answers break down like this. About half of the respondents said they would have saved it anyway. About 10 percent said they would have spent it all, while about 40 percent said they would have spent some and saved some. It is these

latter two groups that are the basis for our savings calculations.

From survey data, we estimated the average IRA contribution from each of these two groups. We then multiplied each of these averages by the appropriate number of households in the population. The final figures indicate that in excess of $10 billion of total IRA contributions in tax year 1983 represented saving which would not have been made in the absence of IRAs. Our estimates of the impact of IRAs on new saving (and the spending-saving behavior of respondents) are not only intuitively reasonable, but they are similar to results obtained in a 1982 survey conducted by the Life Insurance Marketing Research Association.

New Saving Generated By IRA Assets. As we have seen, IRAs prompt some individuals to save more out of current income. The accumulated stock of IRA assets also generates earnings which are automatically reinvested (not spent). These earnings represent another important contribution to new saving.

Initially, the contribution to new saving from this source was obscured. The enormous popularity of IRAs, however, has increased assets and earnings to the point where they can no longer be ignored. As shown in the table below, moreover, growth in IRA assets is still in an early stage.

NEW SAVINGS GENERATED
FROM IRA ASSETS
(Billions of Dollars)

YEAR	IRA ASSETS	NEW SAVING GENERATED FROM ASSETS*
1981	$ 26	---
1982	52	2.1
1983	92	4.2
1984	132	7.4
1989 (ESTIM.)	550+	37.0

*Assumes earnings on IRA assets at the end of the previous year will grow by an average of 8.0 percent.

In 1982, for example, it is estimated that savings generated from IRA assets totaled $2.1 billion. This sum was derived by assuming that IRA assets at the end of 1982 ($26 billion) earned a nominal 8.0 percent during 1982. This procedure was repeated for other years shown in the table.

Since IRA assets are in a sharply rising trend, saving generated from this source follows a similar course. By the end of 1989, IRA assets could hit $550 billion or more and new saving generated from assets could total around $37 billion.*

*The projection of IRA assets and new saving at the end of the decade reflects conservative estimates of: (a) The number of IRA owners; (b) The average annual IRA contribution by households; and (c) The average total return on accumulated assets. Our 1989 projections do not assume any significant changes in the current IRA program--either enhancements or restrictions. Such changes would, of course, alter the outlook.

Unlike our earlier estimate of saving out of current income, saving generated from assets does not take into account the possibility that households may have offsets to their accumulations. The reason for this is straight-forward: There is no quantitative basis for concluding that, in the absence of IRAs, households would have saved an amount equivalent to earnings on accumulated IRA assets. Nor, is there any conclusive evidence which suggests that households might actually reduce saving in other forms because they are achieving their retirement goals through the IRA program. Some offsets may well occur, particularly in the "out" years. Nevertheless, the net saving associated with earnings on accumulated IRA assets is likely to be significant.

The belief that all or most IRA savings are simply a replacement for other forms of saving greatly underestimates both the attractiveness of the incentives to save in an IRA and the deep-seated need of many people to attain a measure of financial security in retirement. The belief that people will actually reduce their rate of saving because of IRAs requires them to be highly rational and have a clear view of the future. These are textbook characteristics not found in most humans. In other words, the "offset" approach assumes that people have specific financial objectives (including dollar goals) and they regularly adjust their spending-saving decisions to achieve them.

In reality, many people allocate their saving to an IRA once a year. Having made their spending-saving decision, the dollars

enter a pool where they become relatively inaccessible. It strains the imagination to assume that people closely follow the amount of earnings (new saving) in their IRA accounts and reduce their other saving, accordingly.

It seems more likely that many people will let their IRA earnings "ride". Even if some of them save somewhat less out of current income for retirement, there are many other important savings goals. People continue to need more money to finance such things as: education; a home; emergencies, and travel. In short, it seems quite reasonable to expect that the rate of saving for retirement will be on the increase (because of IRAs) and saving for other purposes will, at least, hold its own.

Responding To The Skeptics. If IRAs are, in fact, making a net contribution to personal saving, why doesn't it show up in national savings statistics. Let's look first at what's happening to personal saving. Then, we'll try to explain why the impact may not be obvious.

As may be seen in Table II, dollar savings in 1984 are higher than in 1981 for the three concepts shown, but neither the levels nor annual movements are inspiring. The saving rate in the national income accounts, moreover, was 6.1 percent in 1984 (6.3 percent in the 4th quarter). This rate is probably not too different from the long-term average.

There are several reasons, however, why it is not easy to detect the impact of IRAs on aggregate saving. First, new savings associated with IRAs have--up to this point--been quite

small and they get lost in the aggregates. Second, aggregate savings estimates are by no means "carved in stone". Finally, other forces are at work beneath the aggregates which may be offsetting the positive contributions of IRA saving.

Lost In The Aggregates. Some feeling for the aggregate nature of national savings estimates may be inferred from the following brief description of the estimating procedures in the national income accounts. Personal disposal income (after taxes) from all sources is totaled--about $2.5 trillion. Then, all types of personal spending are estimated. Saving is the residual--obtained by subtracting spending from income. Thus, all of the errors that are embodied in the income and expenditure areas are embodied in the savings numbers. The IRA market gets little, if any, separate attention.

Which Aggregate Should You Believe. The Federal Reserve also constructs savings estimates which are conceptually similar to the national income approach. The Fed, however, measures saving as the difference between the change in total assets and liabilities of key sectors in the American economy. Household savings are also determined as a residual. It is what's left over after the assets and liabilities of key sectors (for which information is available) are added together and subtracted from estimated totals.

In recent years, the difference between the two estimates of aggregate saving have ranged between $50 billion and $73 billion (Table II). In short, aggregate estimates are gross, suspect,

and don't deal with a tiny sector (tiny at this point) like IRAs.

Offsets In Other Areas. Finally, IRA contributions to total saving may be influenced by declines in other areas. For example:

(a) The propensity to save may be influenced by the phase of the business cycle. In periods of expansion, people tend to spend more and save less.

(b) The age structure of the population is shifting so that there are relatively more people in the age 18 to 35 group--a group which tends to save less according to life cycle analysis.

In summary, the impact of IRAs on saving appears to be positive, based on what we know about many details of that specific marketplace and the way people behave. If the contributions of IRAs cannot be detected in national savings statistics, it may be that the aggregates themselves are suspect or that other negative forces are offsetting their positive influence.

TABLE I

PERSONAL SAVING IN SELECTED COUNTRIES
RATIO OF SAVINGS TO DISPOSABLE INCOME

YEAR	U. S.	FRANCE	GERMANY	UNITED KINGDOM	CANADA	JAPAN
1970	8.0	16.7	14.6	9.3	5.3	18.2
1978	6.1	17.5	13.3	12.1	10.8	20.6
1979	5.9	16.2	13.9	12.9	11.3	18.7
1980	6.0	14.7	14.2	14.8	12.1	19.2
1981	6.7	15.6	14.9	12.5	13.8	19.7
1982	6.2	15.5	14.4	10.8	15.1	17.7
1983	5.0	(NA)	13.2	8.4	12.9	(NA)
1984	6.1	--	--	--	--	--

NOTE: Saving data for the U.S. are from the Economic Report to the President, 1985; the data for other countries are from the Statistical Abstract Of The U.S. 1985, page 435. NA means "not available."

TABLE II

THREE MEASURES OF SAVING*

YEAR	COL. 1 INCREASE IN[1] FINANCIAL ASSETS	COL. 2 NATIONAL INCOME ACCOUNTS 2	COL. 3 FLOW-OF-FUNDS ACCTS 3	COL. 4 DIFFERENCE BETWEEN COL.2 AND COL.3
1980	$326.3	$110.2	$165.3	55.2
1981	350.0	137.4	192.0	54.6
1982	369.9	136.0	209.7	73.7
1983	450.0	118.1	175.8	57.7
1984	498.9	156.8	204.6	47.8

*Data are compiled from the report, "Federal Reserve Flow-Of-Funds Accounts, Fourth Quarter 1984", page 53.

1 Increase in financial assets of individuals; these figures represent the combined change of households, farm business, and non-farm non-corporate business.

2 Personal saving from the National Income Accounts is the difference between disposable personal income and personal expenditures. Saving is a residual calculation and includes whatever errors are embodied in the estimate of income and expenditures.

3 Flow-Of-Funds saving is the change in asset holdings minus the change in liabilities. In the FOF, the household sector's holdings of such assets as corporate bonds, equities, etc. are inferred as transaction account residuals. Thus, to the extent that estimates of either the total amount of the asset outstanding or any other sector's holdings of the asset are in error, the household sectors inferred estimate will also be in error.

The CHAIRMAN. I would like to ask you a question, Mr. Cohen, and it is following what Senator Bradley was asking earlier. This is total savings, net savings. Are we increasing our savings or are we simply shifting them around? I have the staff bring up to date for me each year our total percentage of savings in this country. They actually reached a peak when you were in the Treasury, and I am sure it was directly due to the work that you did there. In 1971, 1972, 1973, we were up around 8.1 or 8.2 percent of our GNP on savings. All during the 1950's and 1960's, which were great boom years for this country, 7, 7.25, 6, 6.75, around there. I haven't seen where we are for the last year yet, but with all the things that we passed to encourage savings, they don't seem to in toto grow very much. I mean, they grow in total, but not in percentage. We don't approach Europe. We don't approach Japan. Is there a reason why they don't grow, or should we even be concerned that they don't grow with all these incentives?

Mr. COHEN. Mr. Chairman, I am not an economist, and so, when you deal on a macroeconomic basis, I don't feel qualified to explain why we have a lack of savings growth, as Japan and other countries have. We certainly were concerned with this at the Treasury, and I am sure the Treasury today is equally concerned. I think that, as applied to the IRA's, the legislation that was adopted in 1981, as an expansion and as a simplification of the IRA's to make it universal, has contributed a great deal, but I think that the total amount in the IRA accounts now, even at $175 billion, is a drop in the bucket of the total savings of the Nation. If the trend of IRA contributions continues, the survey made last year would indicate that by the end of this decade, we will have some $500 billion in IRA accounts. And that will begin to make a dent in the savings total, but at the current levels that we have, it is not enough to show up.

The CHAIRMAN. You think that will be an increase in net savings? It isn't going to be a shift from some other savings?

Mr. COHEN. The survey attempted to answer that question. This was part of some of the dialog earlier as to what is the source of the contributions that are made to IRA's. Now, one point made by Professor Halperin, who was with me at the Treasury when we designed the IRA, is that amounts can be borrowed to put into the IRA and the interest can be deducted. And that is a fact. But we tried to find out in the survey whether any significant number of people had done so, and we found that it was very small, not enough to be statistically relevant.

So, though the possibility exists that one can borrow and deduct the interest and put the money in the IRA, I do not think—from the survey at least—that this has been prevalent. I might say that the problem of deductibility of interest is related not just to IRA's but to other types of investments for businesses and otherwise. It is very difficult to deal with the interest deduction. One can borrow money to pay his State income tax and deduct both the tax and the interest, or one can borrow money to make a charitable contribution and deduct both. So, when you deal with the interest deduction problem, you are dealing with a major issue. We have dealt with it, for example, to prevent borrowing money to buy tax-

exempt bonds, but we have got very limited provisions relating to interest deductions.

Let me say as to whether this represented just a conversion of prior savings into IRA's—which is, I think, the major issue that Senator Bradley was speaking to—the survey asked of those who responded what was the source of the money that they put into IRA's. The best indications we have had, and Mr. Johnson, the chief economist of the institute is here also to tell more about this if you would like, is that some $10 billion of the amounts contributed to IRA's in 1983 came out of money which the respondents to the survey said they would otherwise have spent. And further, some $4 billion came from interest on amounts already in the IRA's. So if you take those two together, you have some $14 billion that would not otherwise have gone into savings. We roughly estimate that would be at a level of some $17 billion today.

Now, I would caution, as a lawyer and not as a surveyor or an economist, that it is very difficult to get someone to tell you really where the money came from to put into an IRA or to buy an automobile or to buy a refrigerator.

The CHAIRMAN. I don't think anybody knows exactly where it comes from, but what we do know is our net savings aren't going up—our percentage.

Mr. COHEN. Yes; my only point was, with respect to the IRA's, that the program is too new to have a major impact on the totality of savings and that, over the years if it continues, it will have that impact.

The CHAIRMAN. Mr. Holan, you are an economist?

Mr. HOLAN. Senator, I think part of what is not counted in personal savings are the savings within plans themselves. And when you talk about the 5-percent figure, I don't even know if it includes IRA contributions as personal savings. If you ask an individual what savings he has, I doubt very much if he or she would include the IRA amounts.

The CHAIRMAN. Now, wait a minute. You said it doesn't include the savings within plans themselves. What do you mean?

Mr. HOLAN. Well, we have voluntary savings in 60 percent of the profit-sharing plans. To give you an example, we have an incentive plan for our staff. I put in 10 percent of my pay voluntarily into the plan, which is not matched.

The CHAIRMAN. Wait a minute. Who does not count what? I don't understand your answer.

Mr. HOLAN. In the surveys that I have seen of personal savings, where they say the American people are saving 5 percent of their money, that includes, as far as I know, only savings accounts in banks.

The CHAIRMAN. Oh, no. You see, that is not the figure I am talking about.

Mr. HOLAN. All right.

The CHAIRMAN. I am talking about a Treasury figure relating to total savings. They even count the money that is invested in capital stock each year. They count the inside buildup on life insurance. They count the total savings in the country.

Mr. HOLAN. I see. Do they include the savings in plans?

The CHAIRMAN. Yes; they are not asking individuals how much do you save because, clearly, there, my hunch is that most individuals would not realize they have a buildup in life insurance. They probably wouldn't think to count it at all. And that would be an invalid way of polling.

Mr. HOLAN. Yes.

The CHAIRMAN. Senator Long.

Senator LONG. Let me just say that I am glad to see Mr. Chen back here. I enjoyed your statement to the committee. I would just like to ask you your general thoughts on a matter. What percentage of Americans do you think we are managing to get into savings by virtue of the IRA's and these various other plans, profit sharing and the others? What percentage of the work force are we managing to cover by these private plans now? That is the IRA's, the 401(k) plans, the ESOP's and all the rest of it? What percentage of Americans do you think are in one kind of plan or another?

Mr. COHEN. I don't know the current figures, Senator Long. Let me offer a statement I was going to make about our objective when I was at the Treasury, and Professor Halperin and I were there at the same time. After the 1969 Tax Reform Act was passed, we had been asked to deal with this issue of trying to expand the coverage of employees. One reason that we designed the IRA was because we wanted to try to increase the private retirement plan coverage for employees. A desirable feature would be to see that as many workers are covered by supplementary private pensions, in addition to Social Security, as we could. And my recollection, is that at that time we found that about half the work force was covered by private pension plans and half were not. Those who worked for major corporations were covered by pension plans, but the fellow who worked for the gasoline station or the corner drugstore wasn't going to have a private pension available for him at his retirement. So, the IRA was designed to give him the opportunity to save for retirement on the same tax deductible basis as would exist for the employee of a company that had a retirement plan.

Now, the problem was that you had to select a dollar limit for the IRA contributions because, if you made it too high, we were concerned that the principal owners of the business—the managers, the top executives—would simply use the IRA for their savings and not provide a plan for the lower paid employees. So, we didn't want to have the IRA so high in its limit that it would interfere with company pension plans. We still wanted to encourage company pension plans that were nondiscriminatory. So, we set the top IRA figure at $1,500, which we suggested to the Congress, thinking that the Congress would pick its own number. By the time ERISA was passed in 1974, the $1,500 figure stuck, and that was raised to $2,000 in 1981. I think if you raised it too much, it would interfere with company provided pension plans that are nondiscriminatory and benefit the lower paid workers as well.

Senator LONG. You mentioned 1969. I think that was the year when you and I managed to get our heads together at the 11th hour or maybe the 23d and managed to at least get a 50-percent tax rate for some income. I think we managed to save it for what we called earned income at that point.

Mr. COHEN. Earned income.

Senator LONG. That is the best we could do at the time. So, I think for one trying to get the tax rate down, you are an old veteran in trying to get it down. You and I worked together on that at the time. It was all we could do to get a 50-percent rate for only earned income.

Mr. COHEN. That is right. That was the last decision made in the conference on the 1969 bill, and I am very grateful to you for that.

Senator LONG. It almost blew the conference up, but it was worth doing. [Laughter.]

Mr. COHEN. It was at 3:30 in the morning, as I recall.

Senator LONG. It is good to see you back here again, Mr. Cohen.

Mr. COHEN. If I may, Mr. Chairman, I would like to note how 401(k) came into existence. Back in 1953, I was in private practice in New York, and several employers there had retirement plans integrated with Social Security that were reasonably generous retirement plans. They also had a cash profit-sharing plan, and they decided that they would like to convert the profit-sharing plan into a supplementary deferred compensation plan which would provide supplemental retirement benefits on retirement. But the thought was that some of the workers might prefer to have the cash profit sharing currently if they had need for money for education of their children or support of their parents or illness in the family and not have the larger retirement benefits afterward. And through the years, one problem after another with these elective plans has developed and been settled. And I was one of those who negotiated with Professor Halperin when he was at the Treasury in the Carter administration, as a result of which 401(k) was put in the statute. But the origin of it was as a supplement to retirement plans.

The problem that a 401(k) plan standing alone produces is that some workers are going to end up with no retirement plan at all in the private sector because they will take their entire amount out in cash. So, there is a delicate balance that is required, since if the 401(k) plan is the only plan and no retirement benefits are assured, some workers are going to arrive at retirement age with only Social Security.

Senator LONG. Thank you very much.

The CHAIRMAN. Gentlemen, I have no further questions. Thank you for being with us.

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

S14005

July 11

ALAN CRANSTON
CALIFORNIA

United States Senate

WASHINGTON, DC 20510

July 11, 1985

Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate

Dear Bob,

I respectfully request that the enclosed statement of Richard B. Dixon, Treasurer and Tax Collector of the County of Los Angeles, California, be made part of the hearing record of testimony presented today on the subject of the tax treatment of 401(k) plans by the President's Tax Proposals for Fairness, Growth and Simplicity.

Mr. Dixon's statement is particularly significant because he speaks for those public sector employees who enthusiastically participate in 401(k) plans which have been approved by IRS. In addition, Mr. Dixon in his statement argues forcefully and cogently in support of the position of those state and local government entities who view present law as permitting establishment of such plans, notwithstanding suggestions to the contrary in the Treasury's explanation of the 401(k) provisions.

I thank you for your consideration of my request.

Cordially,

Alan Cranston

STATEMENT OF

RICHARD B. DIXON

TREASURER AND TAX COLLECTOR
OF LOS ANGELES COUNTY

BEFORE THE

FINANCE COMMITTEE
OF THE UNITED STATES SENATE

JULY 11, 1985

Mr. Chairman and members of the Committee, thank you for this opportunity to testify. I am Richard B. Dixon and as Los Angeles County Treasurer and Tax Collector I represent here today Los Angeles County. Los Angeles County currently maintains a Section 401(k) plan which has been enthusiastically received, with some 79 percent of eligible employees participating. Accordingly, we are extremely concerned about the President's proposal to eliminate the eligibility of our employees to participate in this Section 401(k) deferred compensation plan. In addition, we are concerned about some of the new limitations which have been proposed concerning these plans, especially the $8,000 limit on contributions. I will address these issues briefly, but first I would like to discuss our main problem with the President's plan, which is the proposed exclusion of the public sector from Section 401(k) eligibility.

I. Exclusion of the Public Sector from Section 401(k) Eligibility

We feel that the proposed exclusion would not only be discriminatory and unfair to dedicated public servants, but would also have much wider negative implications for the country as a whole. Before demonstrating why we think the current proposal should be modified, however, I will briefly discuss the current law as it applies to state and local government employees.

Congress added Section 401(k) to the Internal Revenue Code in 1978. It has proven to be a very popular method for employees to take responsibility for their own futures; while comprehensive statistics are not available, the October 29, 1984 issue of Pensions and Investment Age contains a survey showing that 322 of the Fortune 500 firms maintain Section 401(k) plans, with some 30 additional firms expecting to establish such a plan by 1985. A recent survey of some 228 companies, which was conducted by the Association of Private Pension and Welfare Plans, shows that over 80 percent of those firms maintain Section 401(k) plans, that almost 70 percent of their employees are eligible to participate in such plans, and that of those eligible employees, over 60 percent have elected to participate.

Pension and Investment Age also reports that state and local governments have established Section 401(k) plans under which more than 750,000 public sector employees are or soon will be eligible to join. For instance, Los Angeles County, the city of Dallas, and the states of Tennessee, Colorado, Mississippi, North Carolina, South Carolina, Utah, and Texas, have all either implemented or are implementing such plans, or have received determination letters from the Internal Revenue Service approving plans which will be implemented soon. It stands to reason that even more states and localities will implement such plans if the uncertainty created by the

President's proposal is removed. The reason for this widespread interest is simply that Section 401(k) offers a highly efficient means whereby employees can assure their retirement security.

Under Section 401(k), the employee can designate a portion of his salary to be invested in a qualified profit sharing plan or stock bonus plan. Federal income tax on the amount thus invested is deferred until eventual withdrawal, as is tax on any amounts earned on the funds contributed. The employee is fully taxable, however, upon amounts withdrawn from the plan. In addition, employers may (but are not required to) make matching contributions to the plan, as long as various nondiscrimination requirements are met.

The particularly appealing feature of the Section 401(k) plan is that it provides security; not just in the sense that amounts set aside for retirement provide a measure of security, but in the safeguards which the Code provides. Amounts in a Section 401(k) plan are placed in trust and are inviolate. Thus they are not subject to claims of creditors, whether of the employee or the employer. This insures that the employee will get his money when he needs it. In these days of budget deficits and financial uncertainty for some public sector employers, such protection is not to be taken lightly.

In addition to security, Section 401(k) plans provide a number of benefits as compared to other types of retirement

plans. Under Section 401(k), an employee is entitled to contribute up to 25 percent (with a cap of $30,000) of his or her salary per year, and the employer is permitted to make matching contributions as long as the combined total does not exceed those limits. In contrast, Individual Retirement Accounts and annuities only allow deferral of $2,000 per employee, and there is no matching feature. Section 401(k) plans are fully funded, "defined contribution" plans. Thus, they present a desirable alternative to the possibility of uncontrolled growth, and corresponding inability to pay benefits when due, which is associated with unfunded or underfunded public sector "defined benefit" plans.

Let me illustrate this crucial point using Los Angeles County as an example. Our defined benefit plan currently has assets of $4.9 billion, with over $2.7 billion in unfunded liabilities. Our proposed 1985-1986 budget calls for $331.1 million in employer contributions. Roughly one-third of that employer contribution is to be applied this fiscal year pursuant to a 30 year amortization schedule to fund our unfunded liabilities, based on current mortality tables, with every likelihood that unfunded liabilities will grow as lifespans lengthen. Therefore, Los Angeles County alone is spending over $100 million per year to finance the unfunded liabilities its defined benefit plan has already assumed. A defined contribution plan, in contrast, would not present any unfunded liability to future taxpayers.

Finally, the element of choice associated with Section 401(k) contrasts favorably with the ever-increasing influence of institutional pension funds, which allow huge sums of money to be controlled by relatively few people.

All of these benefits apply whether the employer is a private or a public sector entity. But Section 401(k) plans offer additional advantages to governmental employers. Availability of such plans allows state and local governments to compete more effectively with private industry for the best employees, and also makes it easier to keep such employees once they are hired. Such plans, providing full current funding for retirement security, enable the states to meet their obligations to the employees' future in an economically efficient manner. To the extent Section 401(k) coverage is available, there is not as much need for other retirement programs funded out of general revenues or special state funds and, as discussed above, defined contribution Section 401(k) plans will ease reliance on potentially uncontrollable defined benefit plans. Finally, public sector employees are placed on an equal footing with private sector employees, which is not only fair, but boosts morale and thereby contributes to a more effective work force.

Given all of these undeniable advantages, it would appear that there would have to be compelling reasons for any scheme to limit or eliminate Section 401(k) coverage for public sector

employees; but to the contrary, the administration's proposal offers little rationale for its position. It merely observes that Congress has not specifically stated that public sector employees are eligible for Section 401(k) treatment, and also argues that, due to the availability of section 457, "the extension of [Section 401(k)] to . . . public employers would be unnecessarily duplicative."

The proposal suggests that Congress perhaps did not intend for public sector employers to maintain Section 401(k) arrangements. If such were indeed the case, it is difficult to understand why the Chief Counsel of the Internal Revenue Service would have taken a directly contrary position in G.C.M. 38283, issued February 15, 1980. Indeed, as mentioned above, the Internal Revenue Service has issued private determination letters holding that several such plans, including plans sponsored by the States of Utah, Tennessee, Colorado, Mississippi, and South Carolina, are qualified under Section 401(k).

Since the federal government has consistently taken the position that the public sector is eligible for Section 401(k) treatment, we should examine the sole remaining reason offered in support of this proposal -- that, since deferred compensation plans are available under Section 457, "extension" of Section 401(k) plans to public employees would be "unnecessarily duplicative."

Even if the underlying assumption were true -- that is, even if Section 457 were actually the equivalent of Section 401(k) -- this would be a thin reed on which to base such a far-reaching policy decision. The fact is that taxpayers can often choose more than one method of arriving at equivalent results, and this has never before been considered so detrimental that punitive measures must be adopted. But in this case, the underlying assumption does not bear up under scrutiny. Section 457 plans are simply not a satisfactory substitute for Section 401(k) arrangements.

Section 457 was enacted as part of the Revenue Act of 1978, as was Section 401(k). The legislative history shows that Section 457 was designed to provide governmental employees with income deferral opportunities similar to those available to private sector employees entering into private, unfunded deferred compensation arrangements with their employers. In other words, Section 457 was enacted in order to equalize treatment of public sector employees, not as a "poor relations" substitute for funded Section 401(k) plans. If anything, the enactment of Section 457 demonstrates the laudable intention that public sector employees should have available the same opportunities as private sector employees; this, of course, is the same policy which I would urge with respect to Section 401(k).

Section 457 is in no way an acceptable substitute for a Section 401(k) arrangement, since a Section 457 plan is unfunded, and not protected by a trustee arrangement. Amounts set aside under Section 457 are available to general creditors of the governmental employer. The employee merely has an unsecured contractual claim for his or her account. As discussed previously, I feel that defined contribution plans are far more desirable than defined benefit plans from the employee's -- and taxpayer's -- perspective; but the security provided by the trustee requirement of Section 401(k) will be absolutely crucial to achieving employee and union acceptance of any transition from defined benefits to defined contributions. For these reasons, it is simply inaccurate to imply that availability of Section 457 would in some way make up for the loss of Section 401(k).

As shown above, relegating state and local government employees to Section 457 would result in a real decrease in their possibility for retirement security. But other ill effects also follow. As demonstrated, the proposal has offered no rational basis for distinctions between public and private sector employees in this area. Such discrimination will make it even harder for state and local governments to get or keep a high-quality work force! If the states increase other pension plans in order to counteract this effect, either local taxation will have to be increased to provide the necessary revenues, or

already understaffed offices will have to be cut back even more. Dedicated, productive public servants could not be blamed for wondering whether they are indeed second-class citizens in the eyes of the Federal Government.

Equally important is the fact that this proposal contradicts the underlying thrust of the President's tax reform plan. The policy of distinguishing between otherwise similarly situated public and private sector employees is inconsistent with the quest for horizontal equity which in large part drives the President's tax proposals. We should be concerned with creating a "level playing field," not creating new distinctions and disparate treatments. Finally, serious concerns growing out of our traditional reverence for the federalist system are implicated, on a policy if not constitutional level, by a Federal law which prevents state and local governments from utilizing an appropriate system of compensation available to other employers.

To sum up, I believe that the discrimination inherent in the proposal would have serious negative effects on public sector employers, employees, and on taxpayers as a whole. I urge you give a very hard look at this proposal. If you do so, I am confident you will conclude that the public sector should be allowed to retain Section 401(k) eligibility.

II. Other Proposed Section 401(k) Changes

As representative of Los Angeles County I am obviously primarily concerned with the proposal to remove our employees from the protection of Section 401(k). As I hope I have demonstrated above, such a discriminatory policy will have grave consequences both to our employees and to us. Therefore, I would urge that public sector employees be given the same opportunities and encouragement to save for their retirement as private sector employees. But of additional concern are several proposals which would significantly curtail Section 401(k) benefits for all employees.

The President's plan would modify Section 401(k) so that the maximum contribution per employee per year would be the lesser of 25 percent of gross annual salary or $8,000. In addition, the proposal would revise the anti-discrimination rules aimed at preventing abuses by highly compensated executives. I am sure that you have received and will receive considerable testimony about the general merits of these proposals as they apply to all employees. Therefore I will not burden you with a repetition of that testimony. But I would note that the policy concerns behind these proposals are really not applicable to public sector employers, for a number of reasons.

While there obviously is a range between the highest and lowest government salaries, that range does not compare with the differential found in the private sector. Our executives simply do not make $100,000, let alone the $1 million or more per year that numerous private executives make. To the extent that the $8,000 cap would apply, it would force us to rely on other mechanisms for retirement -- most likely, defined benefit pension plans. For reasons already discussed, I view such a move to be contrary to the direction our policy should be aimed at, which is to reduce our reliance on defined benefit plans.

By its very nature, the public sector plan is not subject to manipulation and abuse. We are constantly under the close scrutiny of the press and the public, and even if we wanted to create plans which would disproportionately benefit highly compensated employees, political reality would not permit us to do so. For these reasons, the concern about potential abuses in the non-discrimination context also seems to be misplaced, and to present administrative burdens on public employers which are not justified by the policy benefits sought to be achieved when considered with reference to public employers.

CONCLUSION

The proposal to do away with public sector 401(k) plans is the wrong policy at the wrong time. It would significantly hinder a large group of people from taking responsibility for

their own retirements, at a time when the continued viability of social security and other defined benefit programs is increasingly questioned. It would unfairly discriminate against a large group of people, and it would prevent the States and local governments from determining for themselves the method of employee compensation and retirement security best tailored to their circumstances. It could drive the best employees away at the very time that it has become increasingly difficult to retain them. I would urge you to consider the effects this proposal would have on state and local taxpayers, and even upon the efficiency of state and local governments; when you do so, I think you will agree that it should be rejected.

WRITTEN STATEMENT OF JAMES ALBERTINE,
DIRECTOR OF GOVERNMENT AFFAIRS OF THE
AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives ("ASAE") is pleased to have the opportunity to present a written statement for the printed record of the July 11, 1985 hearing of the Committee on Finance, U.S. Senate on "tax reform and alternative retirement arrangements" announced in Press Release No. 85-048 issued on June 25, 1985.

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 12,000 individuals representing more than 6,500 national, state, and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of more than 55 million people throughout the world. The overwhelming majority of ASAE's members represent tax-exempt organizations, most of which are either tax exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations either sponsor or are contemplating sponsoring cash or deferred arrangements ("CODA's") also known as 401(k) plans, or unfunded non-qualified deferred compensation plans or both. As a result, ASAE is an interested party to legislative activity in these areas.

"The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" ("President's Proposal") contains three provisions regarding retirement plans that uniquely apply to private sector tax-exempt organizations and public sector employers. First, the President proposes that private sector tax-exempt organizations and public sector employers no longer be permitted to establish and maintain CODA's. Second, the President proposes to establish a set of rules for unfunded non-qualified deferred compensation arrangements of private sector tax-exempt organizations that would be similar to the rules applicable to public sector employers. Those rules for public sector employers are currently contained in Section 457 of the Internal Revenue Code ("Code"). Arrangements conforming to these rules appear to be the exclusive method for providing nonqualified deferred compensation arrangements for private sector tax-exempt employers. Third, the President proposes to eliminate the special limits on maximum contributions to tax-sheltered annuities for employees of certain tax-exempt organizations participating in tax-sheltered annuities. The combined impact of these three proposals would be to reduce the ability of an employee of a private sector tax-exempt organization to save for his or her retirement on a tax-favored basis.

ASAE's written comments will be directed only at the proposals regarding CODA's and non-qualified deferred compensation arrangements. However, ASAE strongly supports permitting private sector employees to continue to save their earnings through tax favored programs designed to provide income security during retirement. Therefore it generally opposes any changes in the current tax-sheltered annuity (403(b) annuity) rules that would jeopardize the retirement security of employees who may participate in these arrangements.

401(k) PLANS

Chapter 14.06, "Revise Cash or Deferred Arrangement (Section 401(k)) of the President's Proposal proposes that 401(k) plans be made available only to taxable employers. Tax-exempt and public sector employers would be precluded from maintaining 401(k) plans.

In the explanation of reasons for change, the President's Proposal is in error when it states that private sector tax-exempt employers may offer their employees tax-sheltered annuities. This is only true for private sector tax-exempt employers exempt from taxation under Code Section 501(c)(3). Trade associations and professional societies exempt from taxation under Code Section 501(c)(6) and other private sector employers generally not subject to taxation do not have access to 403(b) plans.

The President's proposal to eliminate tax-exempt organizations access to 401(k) plans also appears to assume that 401(k) plans and unfunded deferred compensation plans ("457 plans") are equivalent vehicles for retirement savings. This premise is inaccurate for the reasons to be discussed later in this written statement. The primary reason is that an unfunded arrangement in the private sector does not offer adequate retirement income security.

At one time it was unclear whether a tax-exempt organization could maintain a profit sharing plan. In 1983 the Internal Revenue Service ("IRS") released General Counsel Memorandum ("GCM") 38283 dated February 15, 1980, that said that an employer exempt from taxation may have a profit sharing plan. This GCM adopted an economic concept of profits that defined profits as the excess of receipts over expenses. ASAE believes the analysis in this GCM is correct and that private sector tax-exempt employers should be

permitted to continue to provide 401(k) plans to their employees, either as profit sharing plans or money purchase pension plans. ASAE understands that the revenue impact of permitting private sector tax-exempt employers to continue to maintain 401(k) plans for their employees is minimal.

NON-QUALIFIED DEFERRED COMPENSATION PLANS

Chapter 14.10, "Unify Rules for Unfunded Deferred Compensation Arrangements of States and Tax-Exempt Employers" of the President's Proposal proposes that unfunded non-qualified deferred compensation arrangements presently made available to public sector employers under Code Section 457 be made available to private sector tax-exempt organizations. Under the current rules contained in Section 457, a participant may defer each year the lesser of $7,500 or 33 1/3% of his annual compensation. In some ways, 457 plans are comparable to the proposed restructered 401(k) plans and would allow greater percentage deferrals than the proposed restructured 401(k) plans. However, there are two problems with the President's Proposal that would jeopardize the retirement security of an employee of a private sector tax-exempt organization and under current law would restrict participation in these plans to highly compensated employees or a select group of management employees.

The first problem is that the amounts deferred would be unfunded. Therefore, these amounts would be subject to the general creditors of the private sector tax-exempt employer rather than being set aside in an arrangement that would be safe from the general creditors of the employer. This defect greatly reduces the retirement security of an employee because of the uncertainty whether his employer will be financially able to satisfy its

obligations. This concern for fiscal well-being is enhanced because private sector tax-exempt organizations, unlike public sector government entities, do not have the ability to levy taxes to raise revenue. If this program is adopted in lieu of 401(k) plans, employees of private sector tax-exempt employers would not be treated equally with employees of for-profit employers.

The second problem appears to be that 457 plans of private sector employers are not excluded from the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") administered by the U.S. Department of Labor. These ERISA provisions would require 457 plans maintained by private sector employers to be funded if they were made available to employees who were not highly compensated or a member of a select group of management. The drafters of ERISA were concerned that most employees did not have the information about the employer or the bargaining position with the employer to be subjected to the financial risk of unfunded deferred compensation. Unless a specific exemption from the application of Title I of ERISA is provided, as a practical matter, plan participation may need to be limited to highly compensated employees or a select group of management employees, thereby creating an additional disparity between public and private sector employees.

The President's Proposal appears to be a continuation of the controversy started in 1978 when the Treasury Department issued proposed Treasury Regulation §1.61-16 that appeared to override the constructive receipt rules surrounding non-qualified deferred compensation that had developed since at least 1960. Congress, in 1978, restored the status quo to "for profit" employers and created a new status quo for public sector employers and rural electric cooperatives by establishing 457 plans. However, Congress left private sector tax-exempt employers in a state of limbo.

The President's Proposal appears to permit the continuation of certain executive unfunded non-qualified deferred compensation arrangements if such arrangements were negotiated as part of a binding contract and did not permit periodic deferral elections. The proposal states, "The rules permitting the elective deferral of compensation by employees of States on a non-qualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code" [emphasis added]. One would think that this proposal would apply only to those unfunded non-qualified deferred compensation arrangements where employees can periodically in advance elect on a purely elective basis to defer compensation. However, the proposal does not contain any description of what is meant by "elective deferral of compensation". It is difficult to determine from reading the President's Proposal whether this proposal is meant to be the exclusive test for taxation of unfunded non-qualified deferred compensation that does not meet the requirements of the President's Proposal.

ASAE's members are particularly sensitive to the tax incentives for employer-provided fringe benefits such as non-qualified deferred compensation because these incentives affect their ability to attract well-qualified personnel. Industry and associations frequently compete within the same labor pool for individuals who have developed the necessary technical expertise and sensitivity from the industry the association represents. These individuals may come from an employer large enough to afford a comprehensive benefit package even in the absence of tax incentives. That is, certain large employers have the financial resources to compensate employees without concern for income taxation because they can afford to compensate the employee for adverse income tax consequences by increasing the level of compensation.

Because most associations that are members of ASAE are tax exempt and many are small employers, they are concerned about tax incentives that favor for-profit or large employers or create tax disadvantages for tax-exempt or small employers because they create an often insurmountable handicap in attracting highly skilled employees. It would be ironic if Congress would pass a statute that would increase the operating costs for tax-exempt employers after having determined that the type of operation met a social purpose that deserved a tax exemption. The importance of employer-provided fringe benefits, such as unfunded non-qualified deferred compensation to potential employees, particularly those looking to change jobs after acquiring family responsibilities, should not be underestimated.

ASAE strongly urges Congress to adopt the same position for tax-exempt employers regarding non-qualified deferred compensation that it approved in 1978 for "for-profit" employers. As a representative of the employees of tax-exempt associations, ASAE is most concerned with the tax incentives that provide tax-preferred status at the employee level. ASAE believes that private sector tax-exempt associations need the flexibility that unfunded nonqualified deferred compensation arrangements provide an employer in designing adequate retirement income security for executive level employees. These employees are often recruited from other employers late in their careers and often lose substantial retirement income when they move to a new employer at that point in their careers.

CONCLUSION

The President's Proposal challenges Congress to better define the ability of tax-exempt organizations to provide retirement income to their

employees in a tax-favored manner. It appears that the proposal attempts to reduce the loss of revenue from retirement savings and to strengthen the constructive receipt rules for taxation. ASAE proposes that Congress permit private sector tax-exempt employers to continue to maintain 401(k) plans (either as profit sharing plans or money purchase pension plans) and to maintain unfunded non-qualified deferred compensation arrangements that are tailored to the employee's needs on a tax-deferred basis. ASAE believes Congress should adopt ASAE's proposals. These proposals would not materially affect the revenue expenditure for retirement savings or frustrate the Administration's attempts to strengthen the constructive receipt rules for taxation.

The text of the President's Proposal and the statements of Administration officials have emphasized the social and philosophical underpinnings of proposed tax reform. Fairness, simplicity and encouragement of personal savings are primary among these underpinnings. ASAE strongly believes that the use of these sensible and flexible arrangements for encouraging retirement savings for the broadest possible number of American workers should be encouraged further rather than discouraged. In this context, the proposal to eliminate access to 401(k) plans for employees of private sector tax-exempt organizations and the proposal on unfunded non-qualified deferred compensation arrangements for private sector tax-exempt employers are particularly ill-advised. Under the proposals, the retirement income security of employees of private sector tax-exempt organizations would be inferior to that of employees of taxable organizations. This would increase the difficulty for private sector tax-exempt organizations to attract and keep talented employees, particularly at the executive level. These significant

differences in the retirement savings protection for employees of taxable and tax-exempt organizations are not only inequitable, but also defeat the Administration's stated goal of encouraging retirement savings. In short, ASAE believes that employees of private sector tax-exempt organizations should be treated as favorably as employees of other organizations.

ASAE is pleased to be a part of the ongoing dialogue concerning the role of the tax laws in the employee benefit area. ASAE represents a large, well-informed constituency that is extremely interested in this and other employee benefit issues. ASAE welcomes the opportunity to assist the Congress by providing the much needed information it needs to analyze the effectiveness of the current tax law and to consider the need for future changes. ASAE is available to collect and provide you with the information you need to make informed well-reasoned decisions concerning private sector tax-exempt associations. ASAE will continue to communicate with its membership to advise it of the status of Congress' deliberations on this and other issues of interest.

National Association of
State Auditors, Comptrollers and Treasurers

PRESIDENT
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July 22, 1985

Honorable Robert Packwood
Chairman, U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Packwood:

As President of the National Association of State Auditors, Comptrollers and Treasurers, I am writing to express opposition to the Administration's proposal to prohibit all tax-exempt and public employers, including states, from maintaining deferred compensation plans provided for in section 401 (k) of the Internal Revenue Code. The elimination of states from the 401 (k) program is opposed for the following reasons:

1. Prohibiting public employers from maintaining 401 (k) plans, while allowing them to be maintained by private employers, is discriminatory.

2. A number of states have either implemented or are implementing 401 (k) plans, or have received determination letters from the Internal Revenue Service approving plans that will be implemented soon. Forcing states to abandon their 401 (k) plans could be extremely disruptive for both employees and for those state governments that went through major benefit restructuring before implementing their plans.

3. While an alternative deferred compensation plan, provided for under section 457 of the Internal Revenue Code, is available to state employers, it is not comparable to the 401 (k) plan. The 457 plan is unfunded; the 401 is funded. Because 401 (k) plans are funded, and are not subject to the claims of creditors of the state, they are secure ways of assuring fund availability in the future.

4. The Administration's proposal will have a "chilling effect" on further initiatives by state governments to establish plans necessary to meet the retirement needs of public employees.

First Vice President: Roland W. Burris, Comptroller, Illinois; *Second Vice President:* Joan Finney, State Treasurer, Kansas; *Treasurer:* Thomas Hayes, Auditor General, California; *Secretary:* Earle E. Morris, Jr., Comptroller General, South Carolina; *Immediate Past President:* Harlan E. Boyles, State Treasurer, North Carolina

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5. Government at all levels has to compete with the private sector in attracting and retaining high calibre employees. Prohibiting states from establishing 401 (k) plans would place states at a disadvantage in attracting employees.

6. The 401 (k) plans encourage savings by both private and public employees, and this has been one of the primary economic goals of both the executive branch and the Congress in recent years.

As your hearings on the Administration's tax proposal progress, I would be interested in making further comments, especially if serious consideration is given to significantly modifying the basic provisions in 401 (k).

I ask that this letter be included in the record of the hearing you conducted on July 11.

Sincerely,

Anthony Piccirilli

Anthony Piccirilli
President

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TESTOMONY OF BILL GILLIN
NPRC FAMILY FARM TASK FORCE CHAIRMAN
U.S. SENATE HEARING ON TAX POLICY REFORM
SENATOR MAX BAUCUS PRESIDING
BILLINGS, MT, MAY 29, 1985

Thank you Senator Baucus for the opportunity to present the viewpoint of our group on the proposed changes in federal tax laws. The Northern Plains Resource Council (NPRC) formed a Family Farm Task Force approximately 18 months ago and has since been studying, in depth, the factors leading up to the present crisis in agriculture. The Task Force has been exploring possible actions and public policies that could restore agriculture to long-term health and assure the continuation of family owned and operated farms and ranches that have proven so successful in the past. The American people are the best fed people on earth and at a lower percentage of their income than any other nation now or in past history. This should be adequate proof of the success of this system and urgent need to preserve it. We are seeing in the present crisis a very real danger of the family farm or ranch becoming a thing of the past and the ownership and control of agricultural lands being concentrated in fewer and fewer hands with the dangers of monopolistic controls and the prospect of substantially higher food prices.

During our months of study we have found one common factor in almost all aspects of the present agricultural crisis, and that is the effect of federal tax laws as applied to agriculture. Those tax provisions that Congress has over many years put into the federal tax codes in attempts to help agricultural people have all too often been used by high income people for tax haven purposes and the end result has been a drastic negative effect on the bona fide farmers and ranchers.

An excellent example of this in Montana is the sodbusting that has become so common in recent years. Most of the sodbusting has occurred on low-grade land with high potential for erosion. The grain from these operations is being dumped on an already overloaded market. The demand for rangeland for sodbusting has caused the price of these lands to inflate to totally unrealistic heights, making it impossible for young ranchers to compete in buying ranching units.

We are submitting with our written testimony a study prepared by Montana State University on the economics of sodbusting. This booklet will explain how the various tax loop-holes and exemptions have been used to finance these operations and make them very lucrative for high income people. Also included will be a list of the limited partnerships that have been involved in financing John Greytak's First Continental Corporation's sodbusting. This particular group is responsible

for plowing over a half-million acres of grass, with the publicly announced intention of sodbusting over one-million acres. This activity occurring largely as a result of tax policy leads us to believe the tax laws are in dire need of revision if there is any hope of restoring agriculture to long-term financial health.

The abuse of legitimate agricultural tax exemptions by outside investors and speculators has convinced us that the farm program and federal tax revisions should be considered together. The use of agriculture as a tax haven has contributed to the boom and bust cycles so detrimental to family-owned and operated units. It has fostered speculation in land and livestock that intensifies the collapses when they occur, as we are currently experiencing. Investors can buy in and out of agriculture. Family farms get wiped out and often are permanently lost from the agricultural industry. These factors will persist without tax reform, regardless of how carefully Congress constructs a farm program aimed at keeping family farming paramount in America.

The limited partnerships and corporations that have become invovled in agriculture in recent years are receiving an indirect subsidy from the federal government through tax write-offs. They are by no means more efficient than the family-owned and operated units, but they have approximately a two-to-one advantage over

the full-time operators because of these tax write-offs. Then, to penalize the full-time operator still more, these tax haven operators are dumping more and more commodities on an overloaded market, running up the price of land and machinery to unrealistic levels, creating erosion problems, pumping excessive amounts of water from some of the nation's aquifers - even to the extent of depleting them, and putting long-time family-owned operators out of business. All of this is being sponsored and encouraged by the present tax codes. These same tax haven operations have also been the recipients of billions in agricultural support payments, causing farm programs to be discredited in the eyes of the tax-paying public.

Tax policy has been a factor in transforming the livestock industry in recent years dramatically. According to the Center for Rural Affairs, between 1980 and 1982, 30% of U.S. pork producers left the business. Many of these were small or medium-sized operations. In the past year, six major corporations announced expansions that will add nearly one million more hogs per year to U.S. production. In the hog industry, a 1% increase in supply creates a 2% decrease in price. The effect of the increased production on an average producer who sells 1,000 hogs per year would be a loss of $2,400. The rapid industrialization of hog production has closely paralleled tax policies, including such breaks as the definition of certain livestock buildings as "equipment" for tax break purposes.

The Congressional Joint Committee on Taxation recently estimated that farm tax shelters will cost the federal treasury $2.6 billion in revenue between 1985 and 1987. In these deficit-plagued times, this virtual hemorhhage needs to be stopped. Moreover, the deficit is no small contributor to problems of farmers faced with unprecedented high interest rates.

Specific tax provisions that foster off-farm investment in agriculture include: Capital gains; investment tax credits; depreciation (especially accelerated cost recovery system); cash accounting; defining certain livestock buildings as equipment; deductions for interest; and deductions for land conversion from grass to grain or irrigated farming. Many of these are legitimate deductions to the bona fide farmer or rancher operating under the current tax code, and are necessary under these circumstances. If any or all of these provisions are deleted under the pending tax reform proposals there must be a corresponding reduction in the overall tax rates so that these changes will not turn out to be punitive to present and future family farmers and ranchers.

For the time being we encourage the passage of legislation that would limit the amount of outside income that could be put into agriculture and thereby be exempted from federal income tax. We would recommend that this limitation be approximately equal to the national median income. This would allow a young

couple getting started in agriculture to apply the income from one or both working off the farm to their agricultural enterprise without undue penalty.

Other short term solutions can also be implemented, pending comprehensive tax reform, that would help deter tax sheltering in agriculture. We urge you to support legislation that specifically addresses solutions to this serious problem.

Overall, we have arrived at the conclusion that the federal tax system is seriously flawed and needs comprehensive reform if this country is to maximize its resources, labor, and management skills. The well-publicized inequities of the current system have substantially undermined tax-payers' confidence that they are being taxed fairly.

In conclusion, let me reiterate that we favor revision of the federal tax codes, especially those provisions that are undermining family-owned and operated agriculture. The present system is tending to recreate in this country the feudal systems that plagued Europe for centuries and from which most of our ancestors fled when they came to America. The feudal systems of Europe were protected by regiments of soldiers or knights in armor, while what we are seeing created in this country are feudal domains protected by regiments of accountants and tax lawyers.

Thank you.